

2021

## Section 1031 Like-Kind Exchanges: Treatment of Nebraska's Certified Irrigated Acres

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### Recommended Citation

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COMMENT\*

## Section 1031 Like-Kind Exchanges: Treatment of Nebraska’s Certified Irrigated Acres

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\* Carolyn Davis, J.D., University of Nebraska College of Law, Class of 2021. I would like to thank my parents, Chris Even and George Davis, and my partner, Phil Levos, for opening my eyes to the University of Nebraska and Husker Nation, and always pushing me to achieve my goals. I also want to thank my fellow tax colleagues who endured many tax courses and readings of the Internal Revenue Code together.

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## I. INTRODUCTION

Water—a powerful resource involved in daily life. Whether it is for personal use or use in production, water is the liquid fueling advancement. While some areas of the United States have abundant water sources, others do not. Ranging in definition, the Midwest region of the United States has various sources of water: groundwater, surface water, and rainwater.<sup>1</sup>

A prominent use of these water sources in the Midwest region—and specifically in Nebraska—is irrigation.<sup>2</sup> Irrigation is the use of water to encourage growth, otherwise defined as the “watering of land by artificial means to foster plant growth.”<sup>3</sup> Whether using the daily sprinkler to water the backyard grass or using thousands of gallons of water for one acre of farmland, the purposes of irrigation are endless. However, some farmland cannot be irrigated. Farmers must analyze and evaluate the need to irrigate based on the productive use of their land, the land’s location in relation to reliable water sources, and any limitations on water usage established by state, county, or city authorities.

Nebraska, through its twenty-three natural resources districts (NRDs), has placed restrictions on the use of water for irrigation.<sup>4</sup> Each NRD determines whether and how many certified irrigated

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1. ANN BLEED & CHRISTINA HOFFMAN BABBITT, NEBRASKA’S NATURAL RESOURCES DISTRICTS: AN ASSESSMENT OF A LARGE-SCALE LOCALLY CONTROLLED WATER GOVERNANCE FRAMEWORK 26–27 (2015); Richard S. Harnsberger, *Nebraska Ground Water Problems*, 42 NEB. L. REV. 721, 721–26 (1963).
  2. J. David Aiken, *Protecting the Hidden Resource: The Quiet Crisis in Nebraska Pesticide and Ground Water Protection Policies*, 26 CREIGHTON L. REV. 639, 639 (1993); BRUCE JOHNSON ET AL., NEBRASKA IRRIGATION FACT SHEET 1–2 (2011), <https://agecon.unl.edu/a9fcd902-4da9-4c3f-9e04-c8b56a9b22c7.pdf> [<https://perma.cc/26CY-UFUJ>] (stating that between 2002 and 2007, Nebraska had more irrigated land than any other state).
  3. *Irrigation*, MERRIAM-WEBSTER, <https://www.merriam-webster.com/dictionary/irrigation> [<https://perma.cc/9WAF-DZ3L>] (last visited Jan. 15, 2021).
  4. *About NRDs*, NEB.’S NAT. RES. DIST., <https://www.nrdnet.org/nrds/about-nrds> [<https://perma.cc/PEZ6-WJET>] (last visited Aug. 31, 2020).

acres (CIAs) are issued to landowners within the district.<sup>5</sup> These CIAs are acres of farmland held at a premium within an NRD because they are designated with the right to irrigate.<sup>6</sup> Thus, landowners prefer to exchange CIAs under § 1031 of the Internal Revenue Code (the Code) to receive tax deferral benefits of like-kind exchanges.

This Comment argues CIAs are considered real property under § 1031. Before the Tax Cuts and Jobs Act of 2017 (TCJA), like-kind exchanges were allowed for both real property and personal property.<sup>7</sup> Now, like-kind exchanges are limited to real property only.<sup>8</sup> Part II of this Comment provides a detailed explanation of NRDs, CIAs, and § 1031 before and after the TCJA. Part III walks step by step through the § 1031 requirements and argues that CIAs are real property, qualifying for a like-kind exchange with other real property. Part III also addresses the opposing view arguing CIAs are not real property and do not qualify for like-kind exchanges, identifies the implications of both viewpoints, and focuses on the benefits of classifying CIAs as real property. Lastly, Part IV finalizes the discussion with a lasting thought.

## II. BACKGROUND

### A. Natural Resources and Certified Irrigated Acres

Every state is responsible for managing the natural resources within its boundaries. In Nebraska, one of the most important natural resources is water. However, water rights and CIAs create a layer of complexity in determining whether § 1031 applies to their exchange. This Section provides a background into natural resource conservation in Nebraska and concludes with an explanation of CIAs and their use.

#### 1. *Nebraska Natural Resources Districts*

Less than twenty years after Nebraska became a state, residents' concern about the state's natural resources grew, prompting early measures to protect precious natural resources, not only on the surface of the land, but hundreds of feet below.<sup>9</sup> The Nebraska Legislature created different institutions to protect natural resources

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5. NEB. REV. STAT. § 46-702 (Reissue 2010); NEB. REV. STAT. § 46-707(1)(c) (Reissue 2010 & Cum. Supp. 2018); *e.g.*, *Lingenfelter v. Lower Elkhorn Nat. Res. Dist.*, 294 Neb. 46, 881 N.W.2d 892 (2016); *see infra* note 32 and accompanying text.

6. NEB. REV. STAT. § 46-706(30) (Reissue 2010).

7. I.R.C. § 1031 (2005), *amended by* I.R.C. § 1031 (2017).

8. I.R.C. § 1031 (2017); H.R. REP. NO. 115-466, at 72–73 (2017); H.R. REP. NO. 115-409, at 61–62 (2017).

9. RALPH J. FISCHER ET AL., NEBRASKA'S NEW NATURAL RESOURCES DISTRICTS 2–3 (1970); HAZEL M. JENKINS, A HISTORY OF NEBRASKA'S NATURAL RESOURCES DISTRICTS 2 (Rober B. Hyer ed., Neb. Dep't of Nat. Res. 2009) (1975).

including Irrigation Districts in 1895, Drainage Districts in 1905, and Soil Conservation Districts in 1937 (after the Great Depression and the Dust Bowl hit the heartland with great force and power).<sup>10</sup> In 1969, Nebraska condensed the control of 154 special-purpose entities by creating twenty-four NRDs, simplifying into twenty-three NRDs in 1989.<sup>11</sup> By splitting the control of Nebraska's natural resources, the NRDs aim "to solve flood control, soil erosion, irrigation run-off, and groundwater quantity and quality issues."<sup>12</sup>

NRD boundary lines are drawn around Nebraska's eight major river basins and five major rivers including: the Missouri River, flowing along the State's eastern border; the Platte River, stretching the length of Nebraska; the White River, located in the Nebraska panhandle; the Niobrara River, bringing water to the driest portions of northern Nebraska; and the Republican River, located in southern Nebraska.<sup>13</sup> On average, each district covers just over two million acres of land.<sup>14</sup> The Lower Loup NRD, located in central Nebraska, is

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10. JENKINS, *supra* note 9, at 2; *NRD History*, LOWER LOUP NAT. RES. DIST., <https://www.llnrd.org/about/sub-section.html> [<https://perma.cc/F24E-9A83>] (last visited Sept. 6, 2020) (explaining the creation of Soil Conservation Districts to "provide sponsorship for the Soil Conservation Service, part of a federal plan for soil conservation"). The Soil Conservation Districts ultimately became the Soil and Water Conservation Committee in 1951. JENKINS, *supra* note 9, at 2.
  11. Act of Sept. 19, 1969, ch. 9, 1969 Neb. Laws 99, 99–101 (requiring completion by January 1, 1972); JENKINS, *supra* note 9, at 2 (discussing the combination of the Middle Missouri Tribes NRD and Papio NRD into the Papio-Missouri River NRD); J. David Aiken, *Nebraska Ground Water Law and Administration*, 59 NEB. L. REV. 917, 956 (1980); Christina Hoffman & Sandra Zellmer, *Assessing Institutional Ability to Support Adaptive, Integrated Water Resources Management*, 91 NEB. L. REV. 805, 815 (2013); *About NRDs*, *supra* note 4 (noting the clear resistance from the directors and board members of the special purpose districts to condense into twenty-three NRDs).
  12. *About NRDs*, *supra* note 4. In addition to the NRDs' purpose, each NRD has twelve responsibilities:
    - (1) erosion prevention and control, (2) prevention of damages from flood water and sediment, (3) flood prevention and control, (4) soil conservation, (5) water supply for any beneficial uses, (6) development, management, utilization, and conservation of ground water and surface water, (7) pollution control, (8) solid waste disposal and sanitary drainage, (9) drainage improvement and channel rectification, (10) development and management of fish and wildlife habitat, (11) development and management of recreational and park facilities, and (12) forestry and range management.
 NEB. REV. STAT. § 2-3229 (Reissue 2012).
  13. NEB. REV. STAT. § 2-3203 (Reissue 2012); Act of Sept. 19, 1969, ch. 9, 1969 Neb. Laws 99, 101–02; *e.g.*, *About NRDs*, *supra* note 4 (drawing boundaries along hydrologic boundaries and county boundaries in areas where surface water is not as abundant); *NRD History*, *supra* note 10; *Water Planning: Interactive Maps*, NEB. DEPT. NAT. RES., <https://dnr.nebraska.gov/water-planning/interactive-maps> [<https://perma.cc/3WLE-CCAS>] (last visited Mar. 24, 2021).
  14. See BLEED & HOFFMAN BABBITT, *supra* note 1, at 136–37 (rounding to the nearest one thousand acres).

the largest NRD—covering just over five million acres of land. Conversely, the Lewis & Clark NRD, located in northeast Nebraska, is the smallest NRD—covering less than one million acres of land.<sup>15</sup> Although each NRD is charged with governing the natural resources located within its boundaries including, but not limited to, the management of water, soil, minerals, and forests, the most important natural resource in Nebraska is water.<sup>16</sup> With almost 80,000 miles of rivers flowing through the State and over 7,500,000 acres of irrigated land, Nebraska strives to protect this valuable resource through conservation and management.<sup>17</sup>

## 2. Water—A Valuable Natural Resource

A main source of water in Nebraska is the High Plains Aquifer, otherwise known as the Ogallala Aquifer.<sup>18</sup> Extending beneath Colorado, Kansas, Nebraska, New Mexico, Oklahoma, South Dakota, Texas, and Wyoming, sixty-five percent of the Ogallala Aquifer's volume is located in Nebraska.<sup>19</sup> Another main source of water in Nebraska is the Platte River, one of the five major rivers in Nebraska mentioned above.<sup>20</sup> The Platte River includes both the North Platte River, which flows over the North Platte River Basin, and the South Platte River, which flows over the South Platte River Basin.<sup>21</sup> The two sections of the Platte River unite in North Platte, Nebraska, creating the Center Platte River Basin.<sup>22</sup>

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15. *Id.*; *NRD History*, *supra* note 10.

16. Act of Sept. 19, 1969, ch. 9, 1969 Neb. Laws 99, 100–01.

17. Harnsberger, *supra* note 1, at 732, 736, 741; *Nebraska*, NAT'L WILD & SCENIC RIVERS SYS., <https://www.rivers.gov/nebraska.php> [<https://perma.cc/4ZQS-5Y84>] (last visited Sept. 6, 2020); *Nebraska, The Cornhusker State*, NETSTATE, [https://www.netstate.com/states/links/ne\\_links.htm](https://www.netstate.com/states/links/ne_links.htm) [<https://perma.cc/N526-NDE9>] (last visited Sept. 6, 2020) (explaining that water and soil are the two most abundant natural resources within Nebraska, with limited minerals and forests, and little to no oil); *Method of Water Distribution in Fields in the Open: 2018 and 2013*, U.S. DEPT. AGRIC. (2017), [https://www.nass.usda.gov/Publications/AgCensus/2017/Online\\_Resources/Farm\\_and\\_Ranch\\_Irrigation\\_Survey/fris\\_2\\_0028\\_0028.pdf](https://www.nass.usda.gov/Publications/AgCensus/2017/Online_Resources/Farm_and_Ranch_Irrigation_Survey/fris_2_0028_0028.pdf) [<https://perma.cc/EV23-FP5D>].

18. BLEED & HOFFMAN BABBITT, *supra* note 1, at 27.

19. Hoffman & Zellmer, *supra* note 11, at 810–11.

20. *See* Aiken, *supra* note 2, at 678.

21. BLEED & HOFFMAN BABBITT, *supra* note 1; Hoffman & Zellmer, *supra* note 11, at 810–11.

22. BLEED & HOFFMAN BABBITT, *supra* note 1; Hoffman & Zellmer, *supra* note 11, at 810–11; Aiken, *supra* note 2, at 678. Out of the twenty-three NRDs, both the Twin Platte NRD and the Central Platte NRD are located in the Platte River Basin, encompassing the North Platte, South Platte, and Platte River Basins. *Central Platte NRD*, NEB.'S NAT. RES. DIST., <https://www.nrdnet.org/nrds/central-platte-nrd> [<https://perma.cc/M5YZ-A4AL>] (last visited Sept. 6, 2020); *Twin Platte NRD*, NEB.'S NAT. RES. DIST., <https://www.nrdnet.org/nrds/twin-platte-nrd> [<https://perma.cc/96WJ-VAZ8>] (last visited Sept. 6, 2020). These are among the most fertile places in the whole state of Nebraska. JOHNSON ET AL., *supra* note

In addition to the rules and regulations of each NRD, the Nebraska Legislature implemented water well regulations in 1957 with an eye on conserving these important resources.<sup>23</sup> In 1975, less than twenty years later, the Nebraska Legislature implemented a larger system to conserve and manage the water within the state.<sup>24</sup> Under the Nebraska Ground Water Management and Protection Act, the Nebraska Legislature determined the following:

[N]atural resources districts have the legal authority to regulate certain activities and, except as otherwise specifically provided by statute, as local entities are the preferred regulators of activities which may contribute to ground water depletion.

Every landowner shall be entitled to a reasonable and beneficial use of the ground water underlying his or her land subject to the provisions of Chapter 46, article 6, and the Nebraska Ground Water Management and Protection Act . . . <sup>25</sup>

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2, at 5. This Comment will focus on the Twin Platte NRD when referring to NRD specific rules and regulations.

23. NEB. REV. STAT. §§ 46-601 to -692 (Reissue 2010 & Supp. 2019) (stating under section 46-601 “registration of all water wells in this state should be required” and encompassing repealed and transferred statutes, most of which transferred into Chapter 46, Article 7 of the Nebraska Revised Statutes, the Nebraska Ground Water Management and Protection Act); Harnsberger, *supra* note 1, at 732–33. In the interest of clarity, the idea of regulation and conservation of water is not new in Nebraska and did not start in the 1950s alone. BLEED & HOFFMAN BABBITT, *supra* note 1, at 28; FISCHER ET AL., *supra* note 9; JENKINS, *supra* note 9, at 2. For more information relating to the water cycle and the use of wells in Nebraska, please see Philip C. Sorensen’s article entitled *Ground Water—The Problems of Conservation and Interferences*, 42 NEB. L. REV. 765 (1963).

24. NEB. REV. STAT. §§ 46-701 to -756 (Reissue 2010 & Supp. 2019) (including amendments in the early 1980s, 1986, 1996, and 2001); see *Lingenfelter v. Lower Elkhorn Nat. Res. Dist.*, 294 Neb. 46, 53–55, 881 N.W.2d 892, 901–02 (2016). These statutes override and supersede the rules and regulations of each NRD.

25. NEB. REV. STAT. § 46-702 (Reissue 2010) (asserting that the use of groundwater is “essential to the economic prosperity and future well-being of the state and that the public interest demands procedures for the implementation of management practices to conserve and protect ground water supplies and to prevent the contamination or inefficient or improper use thereof”). However, the legislature noted that “ownership of water is held by the state for the benefit of its citizens.” NEB. REV. STAT. § 46-702; see *Bamford v. Upper Republican Nat. Res. Dist.*, 245 Neb. 299, 313, 512 N.W.2d 642, 652 (1994) Nebraska’s common law rule on groundwater is as follows:

“[T]he owner of land is entitled to appropriate subterranean waters found under his land, but he cannot extract and appropriate them in excess of a reasonable and beneficial use upon the land which he owns, especially if such use is injurious to others who have substantial rights to the waters, and if the natural underground supply is insufficient for all owners, each is entitled to a reasonable proportion of the whole . . . .”

*Bamford*, 245 Neb. at 313, 512 N.W.2d at 652 (quoting *Olson v. City of Wahoo*, 124 Neb. 802, 811, 248 N.W. 304, 308 (1933)). At the time of *Olson v. City of Wahoo*, Nebraska courts adopted mixed-use water right rules, combining the American rule and the California doctrine, which focused on the notion that the use of groundwater is the direct or indirect diversion of water. Harnsberger, *supra* note 1, at 730.

An irrigating landowner using more than their “reasonable and beneficial” share of the groundwater in comparison to their residential neighbor causes concern for Nebraska residents. Nebraska’s focus on water conservation leaves the use of irrigation around the State continually up for discussion.<sup>26</sup> As stated at the outset of this Comment, irrigation is the use of water to encourage growth, otherwise defined as the “watering of land by artificial means to foster plant growth.”<sup>27</sup> Artificial means of watering land include, but are not limited to, the use of sprinkler systems, gravity systems, and drip systems.<sup>28</sup> The most common irrigation method in Nebraska involves the use of a sprinkler system with a center pivot.<sup>29</sup> Center pivots rotate a pipe or boom from either the center of a field or in a semi-circle position at the edge of a field, shooting water out of heads or nozzles to irrigate.<sup>30</sup>

### 3. *Certified Irrigated Acres*

Because water is a valuable resource and farmers are dependent on using water for irrigation, NRDs have stepped in to control and regulate the amount of water deployed for such purposes. Among other rights available, each NRD can “[r]equire the reporting of water uses and irrigated acres by landowners and others with control over the water uses and irrigated acres for the purpose of certification by the district.”<sup>31</sup> All NRDs require land within its boundaries to be certi-

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26. Linda Ulrich, *Nebraska’s Irrigation History—It’s Complicated*, 7 GROWING A HEALTHY FUTURE 2, 10–11 (2018), <https://ianr.unl.edu/img/magazine/IANR-growing-fall-2018.pdf> [<https://perma.cc/W9C5-ZXXY>] (identifying that the discussion on the quantity of irrigation started as early as the late 1800s, with great expansion in the 1970s, after “widespread drought, favorable economic conditions, growth-oriented water policies and technological advances with commercialization of center pivots”).
27. *Irrigation*, *supra* note 3. Additionally, irrigation is defined by the United States Geological Survey as the “controlled application of water for agricultural purposes through manmade systems to supply water requirements not satisfied by rainfall.” *Irrigation Methods: A Quick Look*, U.S. GEOLOGICAL SURV., [https://www.usgs.gov/special-topic/water-science-school/science/irrigation-methods-a-quick-look?qt-science\\_center\\_objects=0#qt-science\\_center\\_objects](https://www.usgs.gov/special-topic/water-science-school/science/irrigation-methods-a-quick-look?qt-science_center_objects=0#qt-science_center_objects) [<https://perma.cc/JSH4-QEMU>] (last visited Sept. 6, 2020).
28. *Irrigation Methods: A Quick Look*, *supra* note 27; JOHNSON ET AL., *supra* note 2, at 5 (using data from the 2007 Census of Agriculture and the USDA 2008 Farm and Branch irrigation Survey); PAYTON MCGEE & MEGAN STUBBS, IRRIGATION IN U.S. AGRICULTURE: ON-FARM TECHNOLOGIES AND BEST MANAGEMENT PRACTICES 10–15 (2015).
29. *Method of Water Distribution in Fields in the Open: 2018 and 2013*, *supra* note 17 (gathering data under the 2017 Census of Agriculture); JOHNSON ET AL., *supra* note 2, at 528 (identifying that “[f]our out of five acres under irrigation in Nebraska are irrigated with sprinkler systems”).
30. *Irrigation Methods: A Quick Look*, *supra* note 27.
31. NEB. REV. STAT. § 46-707(1)(c) (Reissue 2010 & Cum. Supp. 2018); *e.g.*, *Lingenfelter v. Lower Elkhorn Nat. Res. Dist.*, 294 Neb. 46, 881 N.W.2d 892 (2016) (upholding the NRD’s power to control the use of water on irrigated acres



fied for it to be irrigated, but each NRD imposes different requirements for certification of these acres.<sup>32</sup> Some NRDs still allow the certification of new irrigated acres. However, the majority of NRDs closed off certification unless the land is historically irrigated.

Generally, CIAs are “the number of acres or portion of an acre that a[n NRD] has approved for irrigation from ground water in accordance with law and with rules adopted by the district.”<sup>33</sup> In other words, CIAs are the number of acres a landowner can irrigate. Irrigation on

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within its boundaries and affirming the cease-and-desist order by the Lower Elkhorn NRD to the farmer’s irrigation of acres without the district’s variance or historically irrigated acres classification).

32. BLEED & HOFFMAN BABBITT, *supra* note 1, at 136–37. The Nemaha NRD and the Upper Big Blue NRD have begun to certify irrigated acres. RULE 5 – UPPER BIG BLUE NATURAL RESOURCES DISTRICT GROUNDWATER MANAGEMENT RULES AND REGULATIONS 5-5, 5-26 (Aug. 20, 2020), [https://www.upperbigblue.org/sites/default/files/files/328/rule\\_5\\_as\\_adopted\\_august\\_20\\_2020mod.pdf](https://www.upperbigblue.org/sites/default/files/files/328/rule_5_as_adopted_august_20_2020mod.pdf) [<https://perma.cc/27TK-8UVC>]; NEMAHA NATURAL RESOURCES DISTRICT MANAGEMENT AREA RULES AND REGULATIONS FOR GROUNDWATER QUANTITY MANAGEMENT AREAS 4, 6, 23 (Feb., 2020), [https://www.nemahanrd.org/sites/default/files/quantity\\_rules\\_regulations\\_updates-final\\_february\\_2020.pdf](https://www.nemahanrd.org/sites/default/files/quantity_rules_regulations_updates-final_february_2020.pdf) [<https://perma.cc/D6UC-Q3LF>]; *see, e.g., Lingenfelter*, 294 Neb. at 56–58, 881 N.W.2d at 902–04 (certifying irrigated acres requires classification as either “historically irrigated acres” or “new groundwater irrigated acres”). Certifying irrigated acres did not commence across the state at the same time, with some NRDs stopping certification after a certain date and others continuing to certify irrigated acres. *See, e.g., LOWER BIG BLUE NATURAL RESOURCES DISTRICT GROUNDWATER RULES AND REGULATIONS 20* (2014), <https://www.lbbnrd.net/Approved%20GWMP.pdf> [<https://perma.cc/AGJ5-D8GW>] (allowing continuous certification of CIAs); UPPER ELKHORN NATURAL RESOURCES DISTRICT GROUND WATER MANAGEMENT PLAN RULES & REGULATIONS 22–24 (Nov. 1, 2019), [https://www.uenrd.org/\\_storage/pagefiles/gwmp\\_rules\\_regs\\_effective\\_nov\\_1\\_2019.pdf](https://www.uenrd.org/_storage/pagefiles/gwmp_rules_regs_effective_nov_1_2019.pdf) [<https://perma.cc/3UQM-HVJM>] (allowing certification until December 31, 2015); LOWER REPUBLICAN NATURAL RESOURCES DISTRICT GROUND WATER MANAGEMENT RULES AND REGULATIONS 12–14 (2018), <https://www.lnrnd.org/docman/docs/560-lnrd-gw-rules-and-regulations-8-10-2017/file> [<https://perma.cc/F3CE-RQ79>] (requiring certification prior to January 2005 but allowing future certification if the land meets certain requirements); RULES AND REGULATIONS ENFORCEMENT OF GROUNDWATER MANAGEMENT AREA OF THE LITTLE BLUE NATURAL RESOURCES DISTRICT 3, 11, 13 (Sept. 15, 2018), [https://littlebluenrd.org/wp-content/uploads/2019/10/Groundwater\\_Management\\_Area\\_Rules-Regs\\_FINAL-9-15-18.pdf](https://littlebluenrd.org/wp-content/uploads/2019/10/Groundwater_Management_Area_Rules-Regs_FINAL-9-15-18.pdf) [<https://perma.cc/RW7Z-HGBA>] (requiring certification by January 1, 2019); LEWIS & CLARK NATURAL RESOURCES DISTRICT MANAGEMENT AREA RULES AND REGULATIONS FOR GROUNDWATER QUANTITY MANAGEMENT AREAS 28 (July 12, 2014), [https://lcnrd.nebraska.gov/sites/lcnrd.nebraska.gov/files/doc/water-resources/2014\\_lcnrd\\_quanity\\_rules\\_regs.pdf](https://lcnrd.nebraska.gov/sites/lcnrd.nebraska.gov/files/doc/water-resources/2014_lcnrd_quanity_rules_regs.pdf) [<https://perma.cc/E29T-ENWS>] (cutting off certification on December 31, 2017); CENTRAL PLATTE NATURAL RESOURCES DISTRICT, RULES AND REGULATIONS FOR GROUNDWATER USE IN FULLY AND OVER APPROPRIATED AREAS 11 (Apr. 24, 2014) [hereinafter CENTRAL PLATTE], [https://dnr.nebraska.gov/sites/dnr.nebraska.gov/files/doc/water-planning/nrd/central-platte/CPNRD\\_RulesRegs2014.pdf](https://dnr.nebraska.gov/sites/dnr.nebraska.gov/files/doc/water-planning/nrd/central-platte/CPNRD_RulesRegs2014.pdf) [<https://perma.cc/B4SV-UBA4>] (cutting off certification on December 31, 2014).

33. NEB. REV. STAT. § 46-706(30) (Reissue 2010).

CIAs mainly comes from groundwater below an owner's land.<sup>34</sup> Groundwater is comprised of water that “moves, seeps, filters, or percolates through [the] ground under the surface of the land.”<sup>35</sup> While uncommon, surface water from lakes, rivers, and streams may also be used.<sup>36</sup>

Once irrigated acres are certified, the owner of the overlying land can transfer the certification by itself to another landowner.<sup>37</sup> For a landowner who does not hold CIAs, the only way to begin irrigating land is through the purchase of CIAs from another, obtaining historically irrigated certification, or purchasing land that includes CIAs.

Transferring CIAs occurs by either transferring only the certification, not the overlying land, or transferring both the certification and the overlying land together.<sup>38</sup> It is important to note that each NRD has different rules on whether transfers of CIAs can be made between land situated in different NRDs.<sup>39</sup> As a hypothetical, landowner Aurora owns 160 acres of farmland, along with eighty CIAs that have been used on the overlying 160 acres. She can sell the certification of

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34. *See also* NEB. REV. STAT. § 46-702 (Reissue 2010) (granting each landowner the “reasonable and beneficial use of the ground water underlying his or her land”); JOHNSON ET AL., *supra* note 2, at 4.

35. NEB. REV. STAT. § 46-706(2).

36. Aiken, *supra* note 11, at 921–22 (explaining that surface water levels are seasonal while groundwater is the accumulation in aquifers of surface water that percolated through of hundreds of feet of soil).

37. NEB. REV. STAT. § 46-739(1)(k) (Reissue 2010) (granting the power to NRDs to prescribe rules regarding the transfer of CIAs within the district); *see* TWIN PLATTE NATURAL RESOURCES DISTRICT, DISTRICTWIDE GROUND WATER MANAGEMENT AREA AND INTEGRATED MANAGEMENT SUB-AREA 21–23 (Aug. 8, 2013) [hereinafter TWIN PLATTE], <https://dnr.nebraska.gov/sites/dnr.nebraska.gov/files/doc/water-planning/nrd/twin-platte/TPNRDRulesRegs.pdf> [<https://perma.cc/J5EZ-KT8W>]; CENTRAL PLATTE, *supra* note 32, at 11–12. The Twin Platte NRD rules require transfers of certified acres be approved by the district, after which the CIAs are decertified from the original overlying land and recertified on the new overlying land. TWIN PLATTE, *supra*, at 19, 22. In addition to other restrictions, the Twin Platte NRD does not allow transfers of CIAs between certain river basins, including transfers between the North Platte River Basin and the South Platte River Basin, or between the North Platte, South Platte, or Platte Basin and the Loup or Republican Basin and requires the proper application for the transfer of CIAs to overlying land not previously certified for irrigation. *Id.* There are no additional rules and regulations outside the standard approval by the NRD for a landowner transferring their CIAs between their various properties within the district. The Lower Loup NRD, located north of the Central Platte NRD and west of the Twin Platte NRD, states that irrigated acres “moved from its original location to another location within a parcel” require fulfillment of the same transfer criteria, even though it is not considered a transfer. LOWER LOUP NATURAL RESOURCES DISTRICT, GROUNDWATER MANAGEMENT AREA RULES & REGULATIONS 29 (May 25, 2019), <https://www.llnrd.org/assets/site/2019LLNRDGroundwaterMgtAreaRules.pdf> [<https://perma.cc/N323-9G5C>].

38. TWIN PLATTE, *supra* note 37; CENTRAL PLATTE, *supra* note 32, at 11–12.

39. *E.g.*, TWIN PLATTE, *supra* note 37, at 24.

eighty CIAs in exchange for other property from landowner Bethany, who owns 200 acres of farmland in the same NRD. In this transaction, Aurora will retain the 160 acres of farmland but will not be able to irrigate any of that land. Bethany will retain her 200 acres of farmland and will only be able to irrigate eighty of those acres.<sup>40</sup> Therefore, the transfer of CIAs is only the transfer of the right to irrigate land within an NRD, not the overlying land.

Although there are 80,000 miles of surface water in Nebraska feeding into the groundwater across the entire state, transforming surface water to groundwater does not happen overnight. This is abundantly clear in the driest areas of the state, including southeast Nebraska and counties located near Nebraska's border with South Dakota and Kansas; there, water is limited—the main reason why most land in those regions is not irrigated.<sup>41</sup> With a large concentration of irrigation in fertile areas, disproportionate amounts of water are used across the state—a motive for the creation of NRDs and conservation of Nebraska's water through CIAs.<sup>42</sup> However, with the ability to transfer CIAs between landowners, it is important to discuss and acknowledge the tax implications of any sale, exchange, or other disposition of such property.

## B. Changing Tax System and § 1031

As with all statutes, regulations, and bodies of law, tax laws have undergone countless changes since their inception.<sup>43</sup> After the Sixteenth Amendment to the United States Constitution passed in 1913,

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40. For more information on the sale of CIAs, please visit Adam Marshall Land & Auction at <https://www.adammarshallauction.com/> [https://perma.cc/TJY2-5AM4], click the tab entitled “Properties for Sale,” and search under “Water Rights.” At the time of writing this Comment, two sets of CIAs were for sale; the first set, ten CIAs near Kearney, Nebraska, in the Central Platte NRD for \$3,000 and the second set, fifteen CIAs for sale in Buffalo County, Nebraska, located in the Central Platte NRD for \$3,500. *15 Certified Irrigate Acres – Central Platte NRD*, ADAM MARSHALL LAND & AUCTION, <https://www.adammarshallauction.com/property/15-certified-irrigated-acres-central-platte-nrd/> [https://perma.cc/N83E-PWXV] (last visited Oct. 5, 2020); *10 Certified Irrigated Acres – Central Platte NRD*, ADAM MARSHALL LAND & AUCTION, <https://www.adammarshallauction.com/property/10-certified-irrigation-rights-central-platte-high-depletion/> [https://perma.cc/LR6D-46LQ] (last visited Oct. 5, 2020).

41. Aiken, *supra* note 11, at 918; JOHNSON ET AL., *supra* note 2, at 3, 5.

42. Domestic groundwater use has preference over all other purposes such as agricultural, manufacturing, or industrial. NEB. REV. STAT. § 46-613 (Reissue 2010) (defining domestic water use as “uses of ground water required for human needs as it relates to health, fire control, and sanitation,” including water for domestic livestock “relat[ing] to normal farm and ranch operations.”); see Aiken, *supra* note 2, at 639.

43. 1 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 1.1, at 1-4 to -7 (3rd ed. 2020); Randolph E. Paul, *History of Taxation in the United States*, 1 WM. & MARY ANN. TAX CONF. 5, 6–8 (1955).

Congress has had the constitutional power “to lay and collect taxes on incomes, from whatever source derived.”<sup>44</sup> The first major overhaul of tax laws occurred in 1939 with the codification of all federal tax laws into Title 26 of the United States Code.<sup>45</sup> With subsequent overhauls in 1954 and 1986, the Code has not seen sweeping reform for the last forty years.<sup>46</sup> But in 2017, Congress passed the TCJA, greatly impacting the use of § 1031 like-kind exchanges.<sup>47</sup>

### 1. Overview of Realization and Recognition Rules

To begin, when an individual sells or otherwise disposes of property, a gain or loss is realized. The seller first adjusts the property’s basis under § 1016, then determines the amount of gain or loss by computing the difference between the property’s adjusted basis and the amount realized for the property, defined as the “sum of any money received plus the fair market value of the property (other than money) received.”<sup>48</sup> Continuing the hypothetical with landowner Aurora, to calculate the gain or loss realized on the exchange of eighty CIAs for other property, Aurora’s adjusted basis in the CIAs is her cost basis plus or minus any adjustments. Since Aurora initially bought the overlying land for \$400,000, a fraction of that is the cost for the underlying water, say \$40,000. However, Aurora’s amount real-

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44. U.S. CONST. amend. XVI; see 1 BITTKER & LOKKEN, *supra* note 43, ¶ 1.1, at 1-7.

45. 1 BITTKER & LOKKEN, *supra* note 43, ¶ 1.1, at 1-10 to -11; Norris Darrell, Taxation in the United States, 68 HARV. L. REV. 729, 729-31 (1955) (reviewing RANDOLPH E. PAUL, TAXATION IN THE UNITED STATES (1954)); *History*, U.S. CENSUS BUREAU, [https://www.census.gov/history/www/reference/privacy\\_confidentiality/title\\_26\\_us\\_code\\_1.html](https://www.census.gov/history/www/reference/privacy_confidentiality/title_26_us_code_1.html) [<https://perma.cc/LVG2-2YGU>] (last visited Oct. 1, 2020).

46. 1 BITTKER & LOKKEN, *supra* note 43, ¶ 1.1, at 1-3 to -4, 1-10 to -11 (including numerous repeals until the Tax Reform Act of 1986 which “shift[ed] away from the use of the tax system to accomplish goals other than the raising of revenue”).

47. I.R.C. § 1031 (2017); H.R. 1, 115th Cong. (1st Sess. 2017). Before 2017, no other substantial changes were enacted to § 1031. 2 BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 44.2, at 44-9 to -10 (3rd ed. 2020) (commencing in 1921 as “the Code’s first nonrecognition provision” and staying relatively intact besides the addition of specialized subsections).

48. I.R.C. §§ 1001(a), (b) (1993), 1011(a) (1969), 1012 (2014), 1016 (2018); 2 BITTKER & LOKKEN, *supra* note 47, ¶ 40.1, at 40-2 to -3 (explaining the adoption of § 1001 was to provide a clear way of determining the amount of gain or loss realized, adopting the methods of the judicial and executive branch); e.g., BRADLEY T. BORDEN, TAX-FREE LIKE-KIND EXCHANGES ¶ 2.1[1], at 2-3 (2d ed. 2015). There are three separate sections to determine a property’s basis. Section 1012 determines basis as the cost of the property. I.R.C. § 1012 (2014). Section 1014 determines basis for property bequeathed, devised, or inherited as the fair market value of the property at the date of death of the decedent. I.R.C. § 1014 (2015). Finally, section 1015 determines basis of gifted property as the basis “in the hands of the donor,” but if the donor’s adjusted basis is “greater than the fair market value of the property at the time of gift,” the donee’s basis in the gifted property is the fair market value of the property at that time. I.R.C. § 1015 (1984).

ized is \$75,000, the amount of other property received for the eighty CIAs. Therefore, Aurora has a gain realized of \$35,000.

The realization of a gain or loss only occurs after a “realization event,” which is not necessarily when the sale or other disposition of property occurs.<sup>49</sup> After a realization event, the realized gain or loss is a recognized gain or loss unless Subtitle A of the Code allows otherwise.<sup>50</sup> The exceptions to § 1001(c), including § 1031, are referred to as “nonrecognition rules.” Nonrecognition rules do not eliminate the tax on realized gain or loss. Instead, the nonrecognition rules defer the payment of tax to a later date or event.<sup>51</sup>

Under § 1031, if an individual realizes a gain or a loss on exchanged property held for “productive use in a trade or business or for investment” for other property of like-kind also held for “productive use in a trade or business or for investment,” then the gain or loss is not recognized.<sup>52</sup> The amount of gain or loss not recognized is the total amount of gain or loss realized.<sup>53</sup> In this situation, that is the difference between the adjusted basis of the transferred property and the amount realized for the property received, the property’s fair market value. In landowner Aurora’s case, the exchange of eighty CIAs for like-kind property would create an amount realized of \$35,000. This however would not be recognized, allowing Aurora to defer the \$35,000 of gain, avoiding the present payment of tax.

If an individual realizes a gain on the exchange of property not solely of like-kind, then the gain is only partially recognized.<sup>54</sup> The amount of gain recognized in exchanges not solely of like-kind is the “amount not in excess of the sum of such money and the fair market value of such other property” that is not of like-kind.<sup>55</sup> In this situa-

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49. *Eisner v. Macomber*, 252 U.S. 189, 210–14 (1920); see 2 BITTKER & LOKKEN, *supra* note 47, ¶ 40.2, at 40-4 to -6; 1 BITTKER & LOKKEN, *supra* note 43, ¶ 5.1, at 5-7, ¶ 5.2, at 5-19 to -20; e.g., *Cottage Sav. Ass’n v. Comm’r*, 499 U.S. 554 (1991); *Haverly v. United States*, 513 F.2d 224 (7th Cir. 1975).

50. I.R.C. § 1001(c) (1993).

51. 2 BITTKER & LOKKEN, *supra* note 47, ¶ 44.1, at 44-3 to -5 (stating that non-recognized gain or loss is not “ready to be taxed (or deducted),” although not permanently discharged).

52. I.R.C. § 1031(a)(1) (2017) (except for real property primarily held for sale). While explaining this exception, the House of Representatives’ Ways and Means Committee stated that “[w]ith the provisions in the bill of increased and expanded expensing under sections 168(k) and 179 for tangible personal property and certain building improvements, the Committee believes that § 1031 should be limited to exchanges of real property not held primarily for sale.” H.R. REP. NO. 115-409, at 255 (2017) (footnote omitted). Effectively, the Ways and Means Committee believed there were sufficient benefits for real property held primarily for sale in the remainder of the Code that § 1031 should also not apply thereto.

53. I.R.C. § 1031(a)(1).

54. I.R.C. § 1031(b).

55. *Id.* (characterizing this extra amount of “money and the fair market value of such other property” not of like-kind as the boot).

tion, that is the difference between the adjusted basis of the transferred property and the amount realized of the non-like-kind property, the value of money received or the fair market value of other property received. However, individuals who realize a loss on the exchange of property not solely of like-kind do not recognize the loss.<sup>56</sup>

Again, connecting this to landowner Aurora's case, the original example must be slightly changed. Instead of receiving only like-kind property for the eighty CIAs, say Aurora received \$10,000 in cash in addition to other like-kind property, totaling an amount realized of \$75,000. Under these facts, Aurora will still have a gain realized of \$35,000, the difference between the amount realized of \$75,000 and the adjusted basis of the CIAs of \$40,000. However, the gain recognized is only the amount of cash received, \$10,000, also referred to as the "boot." Therefore, Aurora is still able to defer the recognition of \$25,000 of gain, just in a smaller amount compared to an exchange solely of like-kind.

## 2. Section 1031 History

To qualify as a like-kind exchange, both properties must be: (1) exchanged for; (2) like-kind property; (3) that is held for productive use in either trade, business, or investment.<sup>57</sup> Historically, to qualify as like-kind property, the relinquished and replacement property must both be either real property or personal property.<sup>58</sup> The purpose of holding the properties may be either for a trade or business or as an investment—but not necessarily the same purpose, allowing interchangeable uses.<sup>59</sup> An exchange is not solely of like-kind if both the relinquished and replacement properties are not of like-kind, or when the exchange includes both like-kind and non-like-kind property.<sup>60</sup> Property is not of like-kind if it is not the same type of property (e.g., the relinquished property is real property while the replacement property is personal property).

An example of an exchange not solely of like-kind is relinquishing acres of farmland for replacement personal property such as farm equipment, including tractors, harvesters, or plows. A second example is relinquishing a commercial building for a replacement commercial building along with cash. In both situations, the taxpayer would only

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56. I.R.C. § 1031(b), (c).

57. *LKE and Trade, Business, or Investment Use*, 12 Stand. Fed. Tax Rep. (CCH) ¶ 29,608.04, at 54,628 (2019).

58. See BORDEN, *supra* note 48, ¶ 3.4[2], at 3-45, ¶ 3.4[5], at 3-67 (separating like-kind real property from like-kind personal property).

59. *LKE and Trade, Business, or Investment Use*, *supra* note 57; Treas. Reg. § 1.1031(a)-1(a)(1) (1991) ("[P]roperty held for productive use in trade or business may be exchanged for property held for investment.").

60. I.R.C. § 1031(b).

recognize a gain or loss realized up to the amount of boot. In the first example, the gain recognized would be the full value of the replacement personal property. In the second example, the gain recognized would only be the value of the cash received. Therefore, an exchange not solely of like-kind is not completely cut off from the nonrecognition rules; however, it is significantly limited.

### 3. *Impact of the Tax Cuts and Jobs Act*

The TCJA was first introduced in the House of Representatives on November 2, 2017, by Representative Kevin Brady of the Eighth District of Texas.<sup>61</sup> After eleven days in the House of Representatives' Ways and Means Committee, the House of Representatives passed the Bill on November 16, 2017, by a 227–205 vote.<sup>62</sup> After five days in the Senate and surviving ten motions to move the bill into the Senate Finance Committee, the bill passed with amendments on December 2, 2017, by a 51–49 vote.<sup>63</sup>

Due to these amendments, the bill went back through both the House of Representatives and the Senate. The House of Representatives passed the bill with a final 224–201 vote, and then-President Donald J. Trump waited only one day before signing the nearly 200-page bill into law on December 22, 2017.<sup>64</sup> The TCJA is now codified under Public Law No. 115-97.<sup>65</sup>

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61. *Actions Overview H.R. 1*, CONGRESS, <https://www.congress.gov/bill/115th-congress/house-bill/1/actions> [<https://perma.cc/44R2-6984>] (last visited Feb. 26, 2021); *Representative Kevin Brady*, CONGRESS, <https://www.congress.gov/member/kevin-brady/B000755?searchResultViewType=expanded> [<https://perma.cc/8YN6-5636>] (last visited Feb. 26, 2021).

62. *All Actions Except Amendments H.R. 1*, CONGRESS, <https://www.congress.gov/bill/115th-congress/house-bill/1/all-actions-without-amendments> [<https://perma.cc/Z94Z-2H9L>] (last visited Feb. 26, 2021) (noting that the Constitution of the United States grants the following authority, “[a]ll [b]ills for raising [r]evenue shall originate in the House of Representatives; but the Senate may propose or concur with Amendments as on other Bills.” (citing U.S. CONST. art. 1, § 7, cl. 1)). The House of Representatives’ authority thus includes introducing bills on tax reform and raising revenue through taxation, the main source of revenue in the United States. TAX POLICY CENTER, TAX POLICY BRIEFING BOOK 6 (May 2020) (stating individual income tax revenue is the largest source of that revenue).

63. *All Actions Except Amendments H.R. 1*, *supra* note 62; *Roll Call Vote 115th Congress–1st Session*, U.S. SENATE, [https://www.senate.gov/legislative/LIS/roll\\_call\\_lists/roll\\_call\\_vote\\_cfm.cfm?congress=115&session=1&vote=00303](https://www.senate.gov/legislative/LIS/roll_call_lists/roll_call_vote_cfm.cfm?congress=115&session=1&vote=00303) [<https://perma.cc/2H8G-3P74>] (last visited Feb. 26, 2021). The ten motions were designed to put the Bill into the Senate Finance Committee, which would have given the Senate more time to review the intricacies of the Bill, managing to delay the progress of the Bill. Since the numerous efforts were unsuccessful, the Bill was pushed straight to the Senate floor for a vote. *All Actions Except Amendments*, *supra* note 62.

64. *All Actions Except Amendments H.R. 1*, *supra* note 62.

65. *Id.*

Taking less than two months to become law, the TCJA had a short but powerful run through both the Legislative and Executive Branches of the federal government.<sup>66</sup> However, its vast changes did not affect the reporting of 2017 taxes since most changes went into effect on January 1, 2018. This gave lawmakers, tax preparers (including accountants and lawyers), and the general public over one year to digest, evaluate, and implement the new tax code.

#### 4. Updated Structure of § 1031

No laws are immune from change—not even § 1031 of the Code. Before the implementation of the TCJA, certain property was eligible for a § 1031 exchange,<sup>67</sup> including both real property and personal property.<sup>68</sup> Any property looking to qualify as a § 1031 exchange and to reap the benefits simply needed “like-kind status” with the other property.<sup>69</sup> For farmers, exchange treatment allowed the transfer of equipment such as tractors, harvesters, or plows for other personal property and the ability to defer taxes—an enormous benefit for many individuals.

However, after the TCJA went into effect, personal property became ineligible for a § 1031 exchange, leaving only real property to qualify for tax-deferred like-kind exchange treatment.<sup>70</sup> For property sellers, this made the distinction between real and personal property more important. The line between like-kind property and non-like-kind property, therefore, falls along the line between real property versus personal property.<sup>71</sup>

The current Internal Revenue Service (IRS) Treasury Regulations lack a suitable definition of real property and personal property.<sup>72</sup> However in June 2020, proposed Treasury Regulations finally provided a clear definition of real property for purposes of § 1031 of the

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66. *Id.* The Bill went out of the House of Representatives for the first time on Thursday, November 16, 2017, and the Senate did not receive it until Monday, November 27, 2017, due to a one-week recess for Thanksgiving. *Tentative 2017 Legislative Schedule*, U.S. SENATE, [https://www.senate.gov/legislative/2017\\_schedule.htm](https://www.senate.gov/legislative/2017_schedule.htm) [<https://perma.cc/ST5F-3KMH>] (last visited Feb. 26, 2020).

67. I.R.C. § 1031 (2005), amended by I.R.C. § 1031 (2017) (including real and personal property but only granting exchanges between real property with other real property of like-kind and personal property with other personal property of like-kind).

68. *Id.*

69. *Id.*

70. I.R.C. § 1031 (2017); H.R. REP. NO. 115-466, at 72–73 (2017); H.R. REP. NO. 115-409, at 61–62 (2017).

71. *Real Property as Like-Kind Property*, [2019] 12 Stand. Fed. Tax Rep. (CCH) ¶ 29,608.06, at 54,630.

72. Treas. Reg. § 1.1031(a)-1(c) (1991) (providing only examples of real property exchanges).



Code.<sup>73</sup> If adopted, the proposed Treasury Regulation would provide clarity to both the issue addressed in this Comment and other property on the borderline of § 1031 qualification.

### III. ANALYSIS

Up to this point, this Comment described the NRDs that govern CIAs, provided a detailed explanation of CIAs and their importance, and discussed § 1031 of the Code before and after the TCJA passed. This Part will walk through the four requirements of a § 1031 exchange and argue that CIAs are real property under § 1031 and should receive the benefits of tax-deferred like-kind exchanges. This Comment will also address the opposing view that CIAs are not real property under § 1031, requiring immediate tax collection, and will outline the implications of both classifications.

#### A. Requirements for a § 1031 Exchange

Despite the reduction of § 1031's coverage to real property in the TCJA, § 1031 requirements are largely the same; however, the distinction between real and personal property and what is considered like-kind now requires a more in-depth analysis. To begin, for an exchange to qualify as like-kind under § 1031 of the Code, there must be (1) an exchange; (2) of real property; (3) of like-kind; (4) that is held for use in a trade or business for investment.<sup>74</sup> This Section will walk through each requirement.

##### 1. *What Is an Exchange?*

An exchange is a “this for that transaction” where an item of property is transferred for a different item of property.<sup>75</sup> An exchange is different from a sale where property is transferred for a cash price and nothing more.<sup>76</sup> For property to qualify for § 1031 treatment, an indi-

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73. Prop. Treas. Reg. § 1.1031, 85 Fed. Reg. 35835, 35837 (June 12, 2020) (including a plethora of examples of real property); Abraham A. Reshtick & David K. Salamon, *IRS Issues Proposed Regulations on Section 1031 Like-Kind Exchanges*, NAT. L. REV. (June 22, 2020), [https://www.natlawreview.com/article/irs-issues-proposed-regulations-section-1031-kind-exchanges#google\\_vignette](https://www.natlawreview.com/article/irs-issues-proposed-regulations-section-1031-kind-exchanges#google_vignette) [https://perma.cc/9L6P-Z8Q7].

74. I.R.C. § 1031(a); Bradley T. Borden, *Code Section 1031 After the 2017 Tax Act*, 34 PRAC. REAL EST. LAW. 35, 35 (2018) (identifying the evaluation is more than just whether the property is real property but includes a comparison of “respective interests in physical properties, the nature of the title conveyed, the rights of the parties, and the duration, nature, or character of the properties as distinguished from their grade or quality”).

75. Howard J. Levine & Aaron S. Gaynor, *Taxfree Exchanges Under Section 1031*, 567-5th Tax Mngt. (BNA) A-1, A-12 (April 27, 2020).

76. *Id.*; 2 BITTKER & LOKKEN, *supra* note 47, ¶ 44.2.4, at 44-26.

vidual must make a reciprocal or simultaneous exchange.<sup>77</sup> Therefore, there must be a transfer of one piece of real property—the relinquished property—directly for another piece of real property—the replacement property.<sup>78</sup> While the IRS has previously enforced the reciprocal or simultaneous standard strictly, taxpayers are now able to receive cash for real property and, within 180 days, use the cash to buy like-kind real property.<sup>79</sup> These transactions are, nevertheless, delicate because a taxpayer cannot directly receive any cash for the real property; therefore, an agent is often used to conduct a forward exchange or a backward exchange.<sup>80</sup>

77. I.R.C. § 1031(a)(3) (clarifying that the period is either 180 days or when the taxpayer's tax return is due, whichever is earlier); *Starker v. United States (Starker III)*, 602 F.2d 1341, 1352–55 (9th Cir. 1979) (looking to *Starker v. United States (Starker I)*, [1975] Stand. Fed. Tax Rep. (CCH) ¶ 9443, at 87,142 (D. Or. Apr. 23, 1975), and *Alderson v. Comm'r*, 317 F.2d 790 (9th Cir. 1963), for guidance). If not a reciprocal or simultaneous exchange, the transaction is not a like-kind exchange. I.R.C. § 1031(b); e.g., *Starker III*, 602 F.2d at 1352–55 (holding the decision of the district court in *Starker II* (*Starker v. United States (Starker II)*, 432 F. Supp. 864 (D. Or. 1977)) was wrong and affirming the holding in *Starker I*; *Starker I*, [1975] Stand. Fed. Tax Rep. (CCH) at 87,143 (overruled on other grounds) (holding a valid § 1031 exchange despite the parties agreeing to hold cash value on the business' books after *Starker* transferred his relinquished property and until *Starker* found a replacement property, at which time the business would pay for the replacement property, subsequently transferring it to *Starker*); see Mark Lee Levine, *Simultaneity in Exchanges: Does Code Sec. 1031 Require Simultaneity of the Exchange?*—*Starker II on Appeal*, 58 TAXES—THE TAX MAG. 145, 149–51 (1980). When the IRS first enacted § 1031, the intent was to have a direct property-for-property exchange, without which it appeared the taxpayer was cashing out their investment and any gain or loss realized would be recognized. Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 77, 98 Stat. 494, 595–97 (codified as amended in scattered sections of the I.R.C.); *Starker II*, 432 F. Supp. at 1352–53 (outlining that if the IRS wanted to allow a period gap between exchanged properties as allowed in other sections of the Code, the IRS would have included such language); Levine & Gaynor, *supra* note 75, at A-73. In 1984, after the infamous *Starker* decisions and numerous others pushing the boundary, the IRS clarified the simultaneous or reciprocal requirement, allowing forty-five days to identify the replacement property and creating a 180-day exchange period. John R. Dorocak, *Protecting Real Estate Investors: The Fight To Maintain the Like-Kind Standard for Exchanges Under I.R.C. Section 1031*—“*You Don't Have To Call Me Darling, Darling*,” 33 SANTA CLARA L. REV. 571, 579 (1993); Levine & Gaynor, *supra* note 75, at A-74 to -75. If no replacement property is identified within the time constraints, the transaction is not simultaneous or reciprocal and considered a sale or an exchange of not like-kind property. I.R.C. § 1031(a)(3).

78. However, this does not mean the exchanges must be between two taxpayers. The IRS allows three-party exchanges, permitting A to sell Blackacre to B and C to sell Whiteacre to A so long as all other § 1031 requirements are met. 2 BITTKER & LOKKEN, *supra* note 47, ¶ 44.2.4, at 44-26 to 44-27.

79. See *supra* note 77 and accompanying text.

80. Treas. Reg. § 1.1031(k)-1(a) (2008); Anna E. Eberlin, *The 1031 Exchange in Forward or Reverse: Critical Components and Common Pitfalls*, 58 ADVOCATE 26, 26–27 (2015) (detailing the identification and time requirements for § 1031 ex-

## 2. *Real Property Versus Personal Property*

Property rights are collectively characterized as a “bundle of sticks” and include the right to use, possess, exclude, and transfer one’s property.<sup>81</sup> The classification as real property or personal property is usually straightforward, but for some property (like water rights) classification is not so clear-cut and can even vary among interstate-level authorities.<sup>82</sup>

Real property is “[l]and and anything growing on, attached to, or erected on it,” generally defined as real estate.<sup>83</sup> Under a broad definition, real property encompasses improved and unimproved land.<sup>84</sup> Real estate, the historical term used for real property, is defined as, “primarily land, and everything which is naturally a part of the land.”<sup>85</sup> Unfortunately, the IRS’s Treasury Regulations only provide

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changes). In a forward exchange, otherwise known as a Starker exchange, a taxpayer contracts to sell her real property to a third-party and assigns the contract to a qualified intermediary, who contracts to purchase a new piece of real property. *Id.* Any money received from the second transaction goes to the qualified intermediary who transfers the appropriate piece of real property to each owner once the closing occurs. *Id.* In a backward exchange, otherwise known as a reverse-Starker exchange, the opposite occurs—a taxpayer contracts to buy a third party’s real property. *Id.*; Levine & Gaynor, *supra* note 75, at A-97. The taxpayer will assign the contract to an exchange accommodation titleholder (EAT), who will use the money from the sale to purchase the new real property for the taxpayer. Eberlin, *supra*, at 80; Levine & Gaynor, *supra* note 75, at A-98 to -99 (highlighting the reliance on Rev. Pro. 2000-37 (Oct. 2, 2000), which allows a safe harbor to the use of an exchange accommodation titleholder as the beneficial owner of the relinquished and replacement properties). After the closing on the new piece of property, the EAT will transfer the property to the taxpayer. Eberlin, *supra*, at 80; Levine & Gaynor, *supra* note 75, at A-98 to -99.

81. *Property*, BLACK’S LAW DICTIONARY (11th ed. 2019). Nebraska law defines property as “every kind of property, tangible or intangible, subject to ownership.” NEB. REV. STAT. § 77-102 (Reissue 2018) (the Chapter for revenue and taxation).
82. See William H. Sager, *Property Classification for Taxation*, 43 VA. L. REV. 1325, 1326–27, 1332–34 (1957) (describing that real property includes real estate; tangible personal property includes effects such as household goods and vehicles; and intangible personal property includes company stock, intellectual property rights, and cash).
83. *Real Property*, BLACK’S LAW DICTIONARY (11th ed. 2019). Nebraska law defines real property as:  
 (1) All land; (2) All buildings, improvements, and fixtures, except trade fixtures; (3) All electric generation, transmission, distribution, and street lighting structures or facilities . . . (4) Mobile homes, cabin trailers, and similar property . . . (5) Mines, minerals, quarries, mineral springs and wells, oil and gas wells, overriding royalty interests . . . [and]; (6) All privileges pertaining to real property described in subdivisions (1) through (5) of this section.  
 NEB. REV. STAT. § 77-103 (Reissue 2018) (the Chapter for revenue and taxation).
84. John Charin, *What To Know About Like-Kind Exchange After Tax Reform*, INSIDE BASIS (Section on Tax’n of the Fed. Bar Ass’n, Arlington, Va.), Spring 2019, at 1, 5.
85. *Real Property*, *supra* note 83.

two examples of real property like-kind exchanges: first, between city real estate and farmland and second, between a thirty-year leasehold and fee simple ownership.<sup>86</sup>

On the opposite side, personal property is “[a]ny movable or intangible thing that is subject to ownership.”<sup>87</sup> This includes tangible personal property and intangible personal property, which is both depreciable and non-depreciable.<sup>88</sup> The general asset classes of personal property include, but are not limited to: (1) office property, (2) information systems, (3) data handling equipment, and (4) transportation vehicles, including cars, buses, trucks, locomotives, tractors, trailers, vessels, and airplanes.<sup>89</sup> This list goes on, but fundamentally personal property is best defined by what it is not: personal property is anything that is not real property. Therefore, when looking to CIAs, if they are not determined to be real property, they will default to personal property classification.

### 3. *Determining “Like-Kind”*

Simply because property is deemed real property does not automatically qualify it for § 1031 like-kind exchange treatment.<sup>90</sup> The relinquished real property must also be of like-kind to the replacement real property.<sup>91</sup> To be property of like-kind, the nature of the title conveyed and character of the properties must be similar, as opposed to the properties’ grade or quality.<sup>92</sup> More specifically, the rights of the properties such as the kind, class, and character of the property must be similar.<sup>93</sup> However, these property rights do not need to be identical.<sup>94</sup> Other aspects of the property rights such as the properties’ loca-

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86. Treas. Reg. § 1.1031(a)-1(c) (1991). Under both pre-TCJA and post-TCJA § 1031, real property held primarily for sale was excluded from § 1031 like-kind treatment. I.R.C. § 1031(a)(2) (2017); I.R.C. § 1031(a)(2) (2005) (excluding stocks, bonds, notes, partnership interest, and other personal property from § 1031 treatment in addition to personal property held primarily for sale).

87. *Personal Property*, BLACK’S LAW DICTIONARY (11th ed. 2019). Nebraska law defines personal property as “all property other than real property and franchises.” NEB. REV. STAT. § 77-104 (Reissue 2018) (the Chapter for revenue and taxation).

88. See Treas. Reg. § 1.1031(a)-2 (2005); Borden, *supra* note 74, at 35 (including art, collectibles, and intellectual property such as copyrights).

89. Treas. Reg. § 1.1031(a)-2(b).

90. *Id.*

91. Rev. Rul. 55-749, 1955-2 C.B. 295, at 1; Borden, *supra* note 74, at 36–39 (recognizing four additional definitions of real property under unrelated business taxable income, real estate investment trusts, capitalization, and effectively connected income).

92. Peabody Nat. Res. Co. v. Comm’r, 126 T.C. 261, 273 (2006); Treas. Reg. § 1.1031(a)-1(b) (1991).

93. See *supra* note 91 and accompanying text.

94. *Id.*

tions, attributes, and capacities do not need to be similar.<sup>95</sup> For like-kind status, the focus is mainly on the length of rights and whether there are considerable differences in restrictions between the relinquished property and the replacement property.<sup>96</sup> The Treasury Regulations do not provide great examples of property not solely of like-kind, as they have not been updated since the TCJA was enacted in 2017.

#### 4. *Held for Use in a Trade or Business or for Investment*

To the taxpayer's benefit, the IRS has broadened the fourth requirement to qualify as a like-kind exchange, allowing the relinquished and replacement property to be either held for use in a trade or business or for investment.<sup>97</sup> Thus, both properties do not need to be held for the same use.<sup>98</sup> When evaluating whether an appropriate use is met, the focus is on the intentions of the taxpayer, not the intentions of the relinquishing party.<sup>99</sup>

The term "trade or business" under § 1031 is similar to the definition used throughout the Code, which typically looks to whether there is a legitimate business enterprise and a profit motive,<sup>100</sup> excluding "property devoted to personal use, such as the taxpayer's residence and personal effects."<sup>101</sup> However, profit motive alone is not conclusive.<sup>102</sup> Further, these evaluations weigh the facts and circumstances of each case, changing as facts vary.

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95. *Real Property as Like-Kind Property*, *supra* note 71, at 54,630; *Natural Resources as Like-Kind Property*, [2019] 12 Stand. Tax Rep. (CCH) ¶ 29,608.066, at 54,632; *Koch v. Comm'r*, 71 T.C. 54, 65–68 (1978) (upholding like-kind exchange treatment between unimproved real property and improved real property despite the parcels having long term leases because the right to received income from a tenant is a property right from fee simple ownership); *Like-Kind Property*, BLACK'S LAW DICTIONARY (11th ed. 2019); *see* I.R.C. § 1.1031(a)-1(b).

96. *Estate of Meyer v. Comm'r*, 503 F.2d 556, 557–58 (9th Cir. 1974) (distinguishing a general partnership interest from a limited partnership interest and determining they are not of like-kind because the limited interest does not hold the same responsibilities and liability as the general interest and noting that partnership interests are classified as personal property).

97. *See supra* note 95 and accompanying text.

98. 2 BITTKER & LOKKEN, *supra* note 47, ¶ 44.2.2, at 44-12 to 44-13 (showing that before 1924, the IRS required trade or business use for trade or business use and investment use for investment use); *LKE and Trade, Business, or Investment Use*, *supra* note 57, at 54,628.

99. 2 BITTKER & LOKKEN, *supra* note 47, ¶ 44.2.2, at 44-11 to 44-12.

100. *See supra* note 98 and accompanying text.

101. 2 BITTKER & LOKKEN, *supra* note 47, ¶ 47.3, at 47-29.

102. *Id.* at ¶ 44.2.2, at 44-12 (stating that interpretations of "productive use in trade or business" and "investment" will likely be similar to interpretations of I.R.C. § 1221(2)); *Levine & Gaynor*, *supra* note 75, at A-4; I.R.S. Chief Couns. Mem. 201601011 (Dec. 31, 2015).

However, the term “held for investment” is not defined in the Code or the Treasury Regulations.<sup>103</sup> It has been interpreted to mean “[u]nproductive real estate that is held by a nondealer for future use or future realization of the increment in value.”<sup>104</sup> Unfortunately, regardless if the proper use is met, an important exclusion from like-kind treatment is real property held primarily for sale,<sup>105</sup> for instance when a property owner holds the real property not to make a profit using the land but from later selling the land itself.<sup>106</sup>

In a like-kind exchange, the taxpayer will be in the same economic situation before and after the exchange—in no better position to pay tax because the taxpayer’s cash is tied up in the replacement property.<sup>107</sup> However, if the taxpayer received cash for the relinquished property, the taxpayer would be in a better position to pay tax as the money is no longer in the land, it is liquid.<sup>108</sup>

Each element is critical to the classification of a transaction as a § 1031 exchange, but whether a situation involves an exchange, properties of like-kind, and properties held for use in a trade or business or for investment is heavily dependent on the facts and circumstances of each individual situation.<sup>109</sup> However, with § 1031 limited to exchanges of only real property, the property character of CIAs must be determined. The remainder of this Comment will focus on this element.

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103. Levine & Gaynor, *supra* note 75, at A-4.

104. *Id.*

105. I.R.C. § 1031(a)(2) (2017); 2 BITTKER & LOKKEN, *supra* note 47, ¶ 44.2.2, at 44-13 to 44-14; Treas. Reg. § 1031(a)-1(a) (1991).

106. Levine & Gaynor, *supra* note 75, at A-39 to -40. In *Gangi v. Commissioner*, an apartment building was transformed into individual condominium units and sold, allowing the owners to liquidate their investment. 54 T.C.M. (CCH) 1048, 1050-51 (1987). This property was determined to be held primarily for sale because the sale of the individual units was the ordinary course of this new business, which was different from the previous rental arrangement. *Id.* The following factors are considered when evaluating whether real property is held primarily for sale, “the nature of the acquisition of the property, the frequency and continuity of sales over an extended period, the nature and the extent of the taxpayer’s business, the activity of the seller about the property, and the extent and substantiality of the transactions.” *Id.* at 1051 (quoting *Redwood Empire Sav. & Loan Ass’n v. Comm’r*, 628 F.2d 516, 517 (9th Cir. 1980)).

107. *See* *VIP’s Industries Inc. v. Comm’r*, 105 T.C.M. (CCH) 1890, 1892 (2013); *Peabody Nat. Res. Co. v. Comm’r*, 126 T.C. 261, 276 (2006) (quoting H.R. REP. NO. 73-704, at 564 (1934)); BORDEN, *supra* note 48, ¶ 1.3[2], at 1-14.

108. *VIP’s Industries Inc.*, 105 T.C.M. (CCH) at 1892-93 (holding that a twenty-one year and four-month lease was not of like-kind to a fee simple interest because the replacement property was not within the Treasury Regulation’s statutory safe harbor of thirty years).

109. *See also Real Property as Like-Kind Property*, *supra* note 71, at 54,630 (highlighting that all real property is essentially of like-kind to other real property, therefore the discussion requires a determination of what is considered real property).

## B. Certified Irrigated Acres Are Real Property

Real property is all land, commonly referred to as real estate, and any natural parts attached to that land.<sup>110</sup> Natural resources qualify for like-kind exchange treatment when exchanged for other fee interest in land if (1) both properties have the same character under federal tax law, and (2) the properties are realty under state law.<sup>111</sup> Therefore, federal law first controls water rights' taxable status as real property based on the character, then state law will determine a taxpayer's legal interest in the designated real property.<sup>112</sup>

### 1. Federal Tax Law Regarding Water Rights

Despite the Code or current Treasury Regulations' lack of definition for real property, the proposed Treasury Regulations for § 1031 include a definition of real property historically unavailable.<sup>113</sup> Under the proposed Treasury Regulations, water superjacent to land and unsevered natural products of the land are included in the definition of real property.<sup>114</sup> Unsevered natural products include crops, timber, mines, wells, and other natural deposits and are classified as real property unless "severed, extracted, or removed" from the land they lay on.<sup>115</sup>

Further, to be considered real property, water rights must be perpetual rather than rights to a specific amount of total water for a limited period (i.e. priority, quantity, and duration).<sup>116</sup> A perpetual water

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110. *Real Property*, *supra* note 83.

111. *Natural Resources as Like-Kind Property*, *supra* note 95, at 54,632.

112. *Id.* The proposed Treasury regulations do state that local law *generally* will not control the meaning of real property under § 1031, which is the position taken in the rest of the Code. Prop. Treas. Reg. § 1.1031, 85 Fed. Reg. 35835, 35837 (June 12, 2020); Reshtick & Salamon, *supra* note 73.

113. Prop. Treas. Reg. § 1.1031, 85 Fed. Reg. at 35836 (noting that real property historically eligible for § 1031 exchanges will continue to qualify under the proposed Treasury regulations); Howard J. Levine & Aaron S. Gaynor, *Taxfree Exchanges Under Section 1031*, 567-5th Tax Mngt. (BNA), at A-4 (October 12, 2020). Although other sections of the Code define real property, the IRS states that they should not be used for purposes of § 1031. Prop. Treas. Reg. § 1.1031, 85 Fed. Reg. at 35837. The IRS specifically allows taxpayers to rely upon the proposed Treasury regulations for exchanges after the adoption of the TCJA and before the adoption of the regulations. *Id.* at 35839 (including a plethora of examples of real property); Reshtick & Salamon, *supra* note 73.

114. Prop. Treas. Reg. § 1.1031, 85 Fed. Reg. at 35839; Reshtick & Salamon, *supra* note 73. Each piece of real property for exchange under § 1031 must be evaluated separately with a list of factors that will be included in the updated Treasury Regulations. Prop. Treas. Reg. § 1.1031, 85 Fed. Reg. at 35837.

115. Prop. Treas. Reg. § 1.1031, 85 Fed. Reg. at 35839; Levine & Gaynor, *supra* note 75, at II.A.2.a.

116. *Natural Resources as Like-Kind Property*, *supra* note 95, at 54,632 (citing Rev. Rul. 55-749, 1955-2 C.B. 295, at ¶ 29,608.41 which granted a like-kind exchange between a one-half fee interest in twenty acres of land and water rights in the

right is distinguished from the right to a specific amount of total water or a specific amount of water over a limited period,<sup>117</sup> and though a perpetual water right can be limited through diversion rate and maximum quantity of water per calendar year, it may not be restricted to a certain percentage of the overall supply of agricultural water.<sup>118</sup>

Looking for guidance directly from the IRS in the form of a private letter ruling, a taxpayer successfully argued that a water right is of like-kind to the replacement property.<sup>119</sup> The taxpayer's water rights included the "right to pump ground water from [an aquifer for irrigation purposes and specified tracts of land]."<sup>120</sup> These rights were limited to 1,100 gallons per minute and a maximum quantity of 195 acre-feet over the calendar year.<sup>121</sup> Since the water rights were not limited in duration to a period of years, but rather limited in flow and volume, they reflected similar characteristics as a fee simple interest in land received as replacement property.<sup>122</sup> Although the private letter ruling did not determine whether the exchange qualified for § 1031 treatment, the IRS determined that a taxpayer's water rights were of like-kind to a fee simple interest in farmland.<sup>123</sup>

In contrast, the Supreme Court of the United States in *Wiechens v. United States* determined that, although Arizona law identifies water rights as interests in real property, the properties involved in the proposed § 1031 exchange were not of like-kind.<sup>124</sup> In *Wiechens*, the plaintiffs' water rights were acquired after and under a separate agreement from the purchase of the overlying land.<sup>125</sup> This agreement limited the water rights to fifty years and "7.67 percent of total supply

irrigation district); Rev. Rul. 55-749, 1955-2 C.B. 295, at \*2 (1955); I.R.S. Priv. Ltr. Rul. 200404044 (Jan. 23, 2004).

117. Rev. Rul. 55-749, at \*2.

118. Levine & Gaynor, *supra* note 75, at A-37 (citing I.R.S. Priv. Ltr. Rul. 200404044 (Jan. 23, 2004)); *Wiechens v. United States*, 228 F. Supp. 2d 1080 (D. Ariz. 2002)). A diversion rate is the speed at which water is diverted from its source. An example of water diversion is the pumping of groundwater from its reservoir to the surface for another purpose.

119. I.R.S. Priv. Ltr. Rul. 200404044 (Jan. 23, 2004). Private letter rulings are not binding on courts and are only binding on the parties in the ruling. However, they provide invaluable insight into the decisions the IRS is making.

120. *Id.* (identifying that the "[s]tate retain[ed] the authority to make reasonable reductions in the diversion rate and the quantity pumped as may be deemed to be in the public interest").

121. *Id.* (distinguishing the units for water at rest and units for water in motion).

122. *Id.*

123. *Id.* (stating that private letter rulings cannot be used or cited as precedent). Private letter rulings open the mind of the IRS to the taxpayer. The stances taken in the rulings show how other similar questions may be answered.

124. *Wiechens v. United States*, 228 F. Supp. 2d 1080, 1082, 1084-85 (D. Ariz. 2002).

125. *Id.*



of agricultural water available.”<sup>126</sup> The Court used Revenue Ruling 55-749 to find the plaintiffs’ water right was non-perpetual<sup>127</sup> and therefore, not of like-kind to the replacement fee simple interest in land and disqualified as a § 1031 exchange.<sup>128</sup>

Thus, given the classification of water rights as real property rights under federal tax law and the proposed Treasury Regulations, the focus must shift to state and local law to determine what types of property are included as a real property water right.<sup>129</sup>

## 2. *Nebraska State Law Regarding Certified Irrigated Acres*

With the rules laid out above, one must determine whether CIAs are real property under Nebraska law and whether there are restrictions on the priority, quantity, and duration of the CIA water right. Nebraska law defines property as “every kind of property, tangible or intangible, subject to ownership”<sup>130</sup> and specifically describes land and all its privileges as real property.<sup>131</sup> Nebraska real property owners are entitled to use the groundwater located below their property.<sup>132</sup> Using the groundwater below one’s property must be reasonable and beneficial for the land and cannot be injurious to others who have a substantial right to the groundwater, such as neighboring real property owners.<sup>133</sup> In other words, the right to use groundwater is a real property right because privileges of land owner-

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126. *Id.* at 1084 (explaining that a fifty-year limited right is not the same as a leasehold for thirty or more years, identified in the Treasury Regulations as like-kind property (Treas. Reg. § 1.1031(a)-1(a)(2)(c) (1991))).

127. *Id.*

128. *Id.* at 1085.

129. Rev. Rul. 55-749, 1955-2 C.B. 295, at \*2 (1955) (appearing to be in contrast with the proposed Treasury Regulations for § 1031 which state that local law shall not govern the definition of real property). Despite this potential conflict, the proposed Treasury Regulation definition of real property includes water rights but does not define such rights. Therefore, the seemingly next place to find that definition is the state which controls that right—the state the water is located.

130. NEB. REV. STAT. § 77-102 (Reissue 2018).

131. NEB. REV. STAT. § 77-103 (Reissue 2018) (including “[m]ines, minerals, quarries, mineral springs and wells, oil and gas wells, overriding royalty interests”).

132. *Bamford v. Upper Republican Nat. Res. Dist.*, 245 Neb. 299, 313, 512 N.W.2d 642, 652 (1994); *see also* TRI-BASIN NATURAL RESOURCES DISTRICT RULES AND REGULATIONS FOR MANAGEMENT AND PROTECTION OF LAND AND WATER RESOURCES 22 (May 17, 2016) [hereinafter TRI-BASIN], [https://www.tribasinnrd.org/sites/default/files/Rules%20%26%20Regs/GMA\\_rules\\_06-21-16.pdf](https://www.tribasinnrd.org/sites/default/files/Rules%20%26%20Regs/GMA_rules_06-21-16.pdf) [<https://perma.cc/BU7J-ZAKR>] (“The right to use [g]roundwater for beneficial purposes is a derivative right immediately dependent on ownership of the surface land over a source of ground water.”).

133. *Bamford*, 245 Neb. at 313, 512 N.W.2d at 652; *see also* TRI-BASIN, *supra* note 132 (defining “beneficial use” as utilizing water in amounts reasonable and for allowable purposes).

ship include the right to use one's groundwater, since such use is a derivative right dependent on the ownership of the overlying land.<sup>134</sup>

CIAAs, however, are not as clearly defined as groundwater rights. CIAAs are acres of land that, per approval from the appropriate NRD, can be irrigated by the groundwater lying beneath the land.<sup>135</sup> Outside the historical use of groundwater for reasonable and beneficial use and the ability for the NRDs to track the use of water, there are no current restrictions on the amount of water used for irrigation. By implementing a system where a property owner must obtain approval to irrigate, CIAAs effectively limit the amount of groundwater the property owner may use. Land without CIAAs, therefore, cannot use groundwater for an irrigation purpose. Further, property owners of land with CIAAs cannot irrigate beyond the limits imposed by the NRD, which are based on the amount of water used per year rather than the overall supply.

The transferability of CIAAs also plays an important role in their classification as real property. The NRD must pre-approve a transfer of CIAAs located within its district.<sup>136</sup> An individual seeking to transfer CIAAs within an NRD must submit a title report reflecting the ownership of the CIAAs, the legal description of the land the CIAAs are being transferred to, and all existing liens against the land transferring the CIAAs.<sup>137</sup> Furthermore, the instrument of transfer must be "executed, acknowledged, and recorded in the same manner as conveyances of real estate."<sup>138</sup> For example, the Twin Platte NRD's Rules and Regulations state:

Transfers [of CIAAs] shall be conditioned upon and limited to those in which the land where the right is transferred from remains in dryland agricultural use, or such other non-consumptive uses as have been approved by the District. This restriction shall run with the land, and apply to the transferor's heirs, successors, and assigns. The owner of the land will be required to sign an affidavit and acceptance of offset/mitigation obligations that a new consumptive use will not be created on the land where the right is transferred from. Such affidavit will be filed with the County land records.<sup>139</sup>

. . . .

. . . All offset and/or mitigation obligations described in this transfer Section [i.e., transfer of certified acres] will run with the land, and apply to any

134. See NEB. REV. STAT. § 77-103 (Reissue 2018); *Bamford*, 245 Neb. at 313, 512 N.W.2d at 652; Ronald N. Johnson et al., *The Definition of a Surface Water Right and Transferability*, 24 J.L. & ECON. 273, 278-83 (1981); see also TRI-BASIN, *supra* note 132. Johnson, Gisser, & Werner describe a similar question as posed in this Comment but for water rights held and transferred in New Mexico. Johnson et al., *supra*, at 283-87.

135. NEB. REV. STAT. § 46-706(30) (Reissue 2010).

136. NEB. REV. STAT. § 46-739.01(1) (Reissue 2010).

137. *Id.*

138. NEB. REV. STAT. § 46-739.02 (Reissue 2010).

139. TWIN PLATTE, *supra* note 37, at 19.

and all future owners of the real property that is subject to transfer as described herein.<sup>140</sup>

This description of CIAs' rights is significant because the Twin Platte NRD provides a similar definition to the rights of CIAs as fee simple ownership. Rights associated with CIAs run perpetually and unbroken to heirs, successors, and assigns in the same manner as fee simple interests in real estate, covenants, or encumbrances.

Although both CIAs and irrigation system regulations frequently restrict or otherwise limit groundwater use, both the Nebraska Legislature and the Twin Platte NRD treat CIAs similar to real estate. The transfer process, restrictions, and obligations are similar to the process used for other real property. This lends an almost undeniable interpretation that CIAs are considered real property interests (or at least should be classified as such) and are, therefore, allowed § 1031 like-kind exchange treatment.

### C. Certified Irrigated Acres Are Not Real Property

No argument is safe from opposition. Despite the strong support at both the federal and state levels for the proposition that CIAs are real property, alternative interpretations exist that argue CIAs are not and should not be categorized as real property and therefore, not receive § 1031 like-kind exchange treatment. This section will address interpretations that oppose the classification of CIAs as real property: the first looking at the federal level and the second looking to the state level. As with supportive interpretations, the foundation for these counterarguments is that anything not determined to be real property is thus classified as personal property, typically including tangible personal property and intangible personal property such as intellectual property and cash.

#### 1. Federal Law Opposing Water Rights as Real Property

Focusing first on the federal level, proposed Treasury Regulations promulgated by the IRS specify that local law generally will not control the meaning of real property under § 1031.<sup>141</sup> This is also the position the IRS takes in the rest of the Code.<sup>142</sup> With this understanding, Nebraska law will not be consulted for a definition of real property or to determine whether CIAs are real property, even though state law is very informative.

Proposed Treasury Regulations are just that—proposed. After a proposed regulation is published, the IRS allows the public to offer

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140. *Id.* at 23.

141. Prop. Treas. Reg. § 1.1031, 85 Fed. Reg. 35835, 35837 (June 12, 2020); Reshtick & Salamon, *supra* note 73.

142. Reshtick & Salamon, *supra* note 73.

input for a period of time.<sup>143</sup> This input could be in the form of agreement or heavy criticism in favor of change. Sometimes when responses vary, a proposed Treasury Regulation will stay proposed, and there are a slew of proposed regulations that have never been passed into law.<sup>144</sup> Without full codification as a final Treasury Regulation, a taxpayer “generally may not rely on proposed regulations” unless there is an express statement allowing such reliance.<sup>145</sup> If a proposed regulation would change an existing regulation, a taxpayer may only rely on the proposed regulation for planning purposes.<sup>146</sup> Without a clear stance from the IRS, it is more difficult to determine whether CIAs are real property.

Further, the proposed Treasury Regulations state that a license or permit to operate a business on real property is not considered real property under § 1031 if it “produces or contributes to the production of income other than consideration for the use and occupancy of space.”<sup>147</sup> The occupancy of the space relates to the “use, enjoyment, or occupation of land . . . that is in the nature of a leasehold, easement, or fee ownership.”<sup>148</sup> Thus, it could be argued that CIAs contribute to the production of income, as irrigation of the overlying land is a critical step in the final crop product. Additionally, depending on how each NRD characterizes the irrigation right, a CIA may look more like a license or permit to irrigate, similar to the permits given by NRDs to construct wells.<sup>149</sup> However, it seems more likely that CIAs are used in consideration of running the trade or business of farming and occupying the overlying land, not single-handedly contributing to the production of income. Since a farming landowner would not purchase or use the overlying land without irrigation rights such as CIAs, the use of CIAs is in consideration for occupying the overlying land.

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143. See *Advance Notice of Proposed Rulemaking*, IRS, [https://www.irs.gov/irm/part32/irm\\_32-001-001#idm140524182292688](https://www.irs.gov/irm/part32/irm_32-001-001#idm140524182292688) [<https://perma.cc/WUC3-E5LQ>] (last visited Oct. 10, 2020).

144. See Prop. Treas. Reg. § 1.102-1, 54 Fed. Reg. 595 (Jan. 9, 1989) (gifts from employer to employee); Prop. Treas. Reg. § 1.721-1, 36 Fed. Reg. 10787 (June 3, 1971) (nonrecognition for partnerships). For more examples, visit Bloomberg Law: Tax at [https://www.bloomberglaw.com/product/tax/page/page\\_federal](https://www.bloomberglaw.com/product/tax/page/page_federal), scroll down to the “Statutes & Regulations” box within the right column on the page, then click “Proposed Treasury Regulations.”

145. Mitchell Rogovin & Donald L. Korb, *The Four R's Revisited: Regulations, Rulings, Reliance and Retroactivity in the 21st Century: A View from Within*, 87 TAXES—THE TAX MAG. 21, 22 (2005).

146. *Id.*

147. Prop. Treas. Reg. § 1.1031, 85 Fed. Reg. at 35838.

148. *Id.*

149. See TWIN PLATTE, *supra* note 37, at 9, 16–17.

2. *Nebraska State Law Opposing Certified Irrigated Acres as Real Property*

Focusing next on the state level, Nebraska NRDs currently only limit the rate of water use to a restrictive term of years or percentage use of the total water supply. These types of rights are similar to those at issue in *Wiechens v. United States*, which held that non-perpetual water rights did not meet the requirements for like-kind exchange with a fee simple interest in land.<sup>150</sup>

Further, as stated in section II.A, water conservation in Nebraska is a top concern of NRDs, and with the ever-changing climate, the classification of CIAs is easily subject to change. With each NRD regulated by its own board, one meeting can drastically change the governing rules and regulations, including the rights of CIAs.<sup>151</sup> Under the Twin Platte NRD, the rights of CIAs are spelled out and defined in a real property sense. However, this definition could be taken out or changed at any moment. Further, other NRD rules and regulations do not provide the same detailed description of CIAs as real property. Therefore, those NRDs could fail to define CIAs as real property and instead, interpret CIAs as personal property which do not receive § 1031 treatment.

Lastly, the transfer of CIAs does not occur automatically, even when transferring the overlying land. An applicant must complete a separate application and comply with a separate transfer process that typically requires approval of the transfer from the NRD.<sup>152</sup> These requirements are certainly different than the requirements to transfer real estate through a deed.<sup>153</sup> Further, the added requirements to transfer CIAs are in stark contrast to easements and covenants associated with real property, which often automatically run to subsequent landowners.<sup>154</sup>

#### D. Implications

The classification of CIAs as real property and their qualification for § 1031 like-kind exchange treatment is important for taxation as well as economic purposes. In this final section, these implications will be addressed.

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150. *Wiechens v. United States*, 228 F. Supp. 2d 1080, 1082, 1084–85 (D. Ariz. 2002).

151. Each NRD has the power to establish, “[a]dopt and promulgate rules and regulations necessary to discharge the administrative duties assigned in the act.” NEB. REV. STAT. §§ 46-707 (Reissue 2010 & Supp. 2019), 46-748 (Reissue 2010).

152. TWIN PLATTE, *supra* note 37, at 6, 11, 18–23 (including all requirements upon transferring CIAs).

153. *Id.*

154. *Id.* at 21–23; CENTRAL PLATTE, *supra* note 32.

### 1. *Economic Implications*

Economic implications of classifying CIAs as real property and qualifying for like-kind exchange treatment concern not only the financial nickel-and-diming that occurs,<sup>155</sup> but also the ability to run a business, including elements standing in the way of and the impact of any restrictions on commercial success. For farmers to run a business, they need certain factors to fall into place—weather, seed quality, and the ability to physically perform the work. Although rainfall is a great source of irrigation, artificial irrigation is a prevalent practice in Nebraska that farmers heavily rely upon.<sup>156</sup> Farmland that requires sustained irrigation will become unproductive without farmers' ability to irrigate. Since all NRDs place restrictions on the ability to irrigate unless the acres are certified,<sup>157</sup> CIAs are a crucial part of a farming operation.

In the event a farmer changes the nature of their business from crop-growing to cattle ranching, they will sell either the entire farm operation as-is (including CIAs) or sell only the CIAs, halt irrigation of the land, and start a new production on the same land. Farmers also sell CIAs when their farmland needs a break since the nutrients in the land are depleted every year without adequate time to replenish.<sup>158</sup> Similar to any other business, tax implications are considered when making these changes.

Favorable tax outcomes are incredibly important to farmers because they are land rich and cash poor.<sup>159</sup> Their business' value, along

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155. As discussed in subsection II.A.3, CIAs are constantly being sold whether by word of mouth or by public auction sites. *See, e.g., supra* note 40; *55.47 Certified Irrigated Acres, Water Banked, Twin Platte NRD, Eastern*, NORTH PLATTE TELEGRAPH (Feb. 4, 2020), [https://nptelegraph.com/ads/sale/business/farm/55-47-certified-irrigated-acres-water-banked-twin-platte-nrd-eastern/ad\\_c32c3beb-f664-5974-ab2b-114f4f39f9e6.html](https://nptelegraph.com/ads/sale/business/farm/55-47-certified-irrigated-acres-water-banked-twin-platte-nrd-eastern/ad_c32c3beb-f664-5974-ab2b-114f4f39f9e6.html) [<https://perma.cc/7J4N-CWKB>]; *151 Acres Valley County North Loup Pivot Irrigated & Recreation Land Auction*, RUTHER AUCTION & REALTY (Sept. 21, 2018), <https://www.ruhterauction.com/listings/auctions/819-north-loup-pivot-irrigated-recreation-valley-county-nebraska-land-auction> [<https://perma.cc/7WCT-SHQV>]; *Tri Basin Certified Irrigated Acres Auction*, AGWEST LAND BROKERS, <https://www.agwestland.com/property/tri-state-basin-certified-irrigated-acres-auction/> [<https://perma.cc/S4DX-HV4D>] (last visited Oct. 5, 2020).

156. JOHNSON ET AL., *supra* note 2, at 5; *Irrigation Methods: A Quick Look*, *supra* note 27.

157. BLEED & HOFFMAN BABBITT, *supra* note 1, at 136–37.

158. Terence J. Centner et. al., *Employing Best Management Practices To Reduce Agricultural Water Pollution: Economics, Regulatory Institutions, and Policy Concerns*, 45 DRAKE L. REV. 125, 135 (1997); Richard B. Ferguson, *Preface to NUTRIENT MANAGEMENT FOR AGRONOMIC CROPS IN NEBRASKA* (Richard B. Ferguson & Krista M. De Groot eds., 2006); *see* MCGEE & STUBBS, *supra* note 28, at 33.

159. *See* Janet A. Flaccus, *Taxes, Farmers, and Bankruptcy and the 1986 Tax Changes: Much Has Changed, but Much Remains the Same*, 66 NEB. L. REV. 459, 459 (1987); Karin R. Zeigler, Note, *Who Will Teach Our Farmers: Learning the*

with personal wealth, is almost entirely wrapped up in land and other large assets because they typically only make enough income to offset expenses. Each year's taxable income can be widely different, unlike the ordinary worker, particularly due to the large fluxuations in crop growth, expenses, and transfers of property.<sup>160</sup> This makes a systematic approach to tax planning difficult and, coupled with an inability to keep cash on hand to pay large tax bills, makes any deferral of gains throughout the farming operation an enormous benefit.

Looking further down the road, these deferred gains may never be recognized with the use of the § 1014 step-up in basis. Under § 1014, the basis of property received by bequest, devise, or inheritance is the fair market value of the property at the date of death of the decedent.<sup>161</sup> Thus, as long as a farmer holds CIAs until their death, any deferred gains or appreciation in value will not be recognized, rolling straight over into the subsequent owner's basis.

## 2. Tax Implications

If CIAs are given § 1031 like-kind treatment, the gain or loss realized on the exchange of these acres will not be recognized. Therefore, the basis of the replacement property will be the basis of the relinquished property, adjusted for any additional non-like-kind property received—effectively rolling over the basis from the first property into the second property. Further, the taxpayer's holding period for the replacement property will be tacked onto the holding period from the relinquished property.<sup>162</sup> Applying this to our previous example of landowner Aurora, the replacement property will have a cost basis of \$40,000 rolled over from the relinquished property and will be deemed held for a total of three years since she held the CIAs for the two prior years and has held the replacement property for one year since the exchange.

Examining this issue on a larger scale, the tax implications are greater. Rather than exchanging eighty CIAs, imagine Aurora exchanges 160 CIAs for a strip of land in fee simple absolute near her overlying 160 acres. Aurora's relinquished property has a cost basis of \$80,000 with no adjustments. The replacement property has a fair market value of \$300,000. The gain realized in this exchange is the difference between the amount realized of \$300,000 and the adjusted basis of \$80,000, totaling \$220,000. This gain realized would not be recognized.

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*Value of Mentor Programs from State and Private Programs*, 5 DRAKE J. AGRIC. L. 279, 287–88 (2000).

160. Richard G. Fehrenbacher, *Tax-Planning for Farmers Through the Use of Deferred-Payment Contracts*, 1981 U. ILL. L. REV. 803, 803.

161. I.R.C. § 1014 (2015).

162. I.R.C. § 1223(1) (2018).

If the CIAs are held for one year or less, the recognized gain is treated as ordinary income, rather than capital gain.<sup>163</sup> If Aurora is single, the recognition of \$220,000 of ordinary income alone will place her in the second-highest tax bracket where her taxable income is taxed at thirty-five percent.<sup>164</sup> Therefore, with Aurora's exchange qualifying as a § 1031 exchange, she would save \$52,689.50 in taxes, notwithstanding any other gross income or deductions.<sup>165</sup>

However, if the CIAs are held for more than one year, the recognized gain is treated as long-term capital gain which receives significant tax savings.<sup>166</sup> This gain will be recharacterized as capital gain under § 1231,<sup>167</sup> and if Aurora is single, the recognition of a long-term capital gain of \$220,000 will be taxed at fifteen percent,<sup>168</sup> leaving a \$33,000 tax bill. If CIAs are classified as real property, qualifying for § 1031 like-kind exchange treatment, Aurora will save the entirety of this tax bill for the coming year, and all gains associated will be deferred, rolling into the replacement property. The savings of either \$52,689.50 or \$33,000 will be significant for Aurora as a land rich, cash poor landowner who may otherwise have to liquidate a portion of her business or personal assets to pay the tax bill.

On the flip side, if CIAs are not classified as real property, deemed unable to receive § 1031 like-kind treatment, the gain or loss from the sale, exchange, or other disposition of the irrigation right will be realized, and the amount of gain realized will be gain recognized, but any loss realized will not be recognized on an annual basis. Therefore, in Aurora's situation, the tax determined as a capital gain for \$52,689.50

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163. I.R.C. § 1222(1) (2014). As held for one year or less, these CIAs will not qualify as a capital asset under § 1221 because they fall within the § 1221(a)(2) exception as "real property used in [a] trade or business." I.R.C. § 1221(a)(2) (2017). These CIAs will also not be recharacterized as capital gain under § 1231 of the Code because although they were real property used in a trade or business, they were held one year or less. I.R.C. § 1231 (2017).

164. I.R.C. § 1(j)(2)(C) (2017). This determination is assuming Aurora is unmarried and there are no other surviving spouses or heads of households.

165. For any year after 2018 and before 2026, Aurora will owe \$45,689.50 plus thirty-five percent on the amount over \$200,000 in tax. I.R.C. § 1(j)(2)(C). The amount over \$200,000 is \$20,000, thus owing an additional \$7,000 in tax. The total tax owed on this transaction alone would be \$52,689.50. As with most of the TCJA, the tax brackets will sunset and revert to the pre-2018 rates if not reapproved before January 1, 2026. I.R.C. § 1(j)(1).

166. I.R.C. § 1222(3) (2014).

167. I.R.C. §§ 1231(a)(3)(A), (b)(1) (2017), 1221(a)(2) (2017). Since CIAs are deemed real property held in a taxpayer's trade or business, they will not qualify as a capital asset under § 1221(a)(2) of the Code. I.R.C. § 1221(a)(2) (2017). However, in Aurora's example, the CIAs are real property used in her trade or business that were held longer than one year and will be recharacterized as capital gain under § 1231. I.R.C. § 1231(a)(3)(A), (b)(1) (2017).

168. I.R.C. § 1(h) (2017). This determination is assuming Aurora is unmarried and there are no other surviving spouses or heads of household.



or \$33,000 as ordinary income for will be due immediately upon the submission of her individual income tax return. Further, the replacement property will have a cost basis under § 1012 of the Code equal to the value of cash or other property received and will not be rolled over from the relinquished property. Additionally, the holding period of the replacement property will restart the moment the sale, exchange, or other disposition occurs.<sup>169</sup> Thus, for purposes of receiving capital gain or loss treatment, the taxpayer will have to hold this replacement property for more than one year.

Of course, there are other restrictions on § 1031 exchanges. These restrictions include limits on § 1031 exchanges among related persons, which encompasses business relations, members of the individual's family including the individual's lineal descendants, ancestors, spouse, and siblings.<sup>170</sup> There are also specific timing requirements directing that the subsequent property—the replacement property in a forward exchange or the relinquished property in a reverse exchange—must be identified within 180 days after the initial exchange of the property and forty-five days from the identification of the subsequent property.<sup>171</sup> Finally regulations also dictate whether an exchange is allowed when the property is located in two different NRDs.<sup>172</sup>

#### IV. CONCLUSION

In Nebraska, water is the resource fueling both the economy and daily life, particularly with the use of CIAs. For a farmer to make productive use of their land, they must be able to irrigate. All NRDs have rules and regulations on the certification, transfer, and declassification of CIAs. While farmers are land rich and cash poor, tax implications are an important piece of their yearly outlook. A farmer's ability to characterize CIAs as real property has great implications for their farming operation. However, if CIAs are not given a real property determination, huge disruptions to the agriculture industry will follow.

Section 1031 of the Code did not always limit the type of property used in its exchanges. Nevertheless, change occurs, bringing reexamination of many Code sections, including § 1031. The most significant change to recent tax law is the passage of the TCJA at the end of 2017.

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169. This is due to the failure to qualify under § 1223(1) of the Code.

170. I.R.C. § 267(b), (c)(4) (2015).

171. I.R.C. § 1031(a)(3) (2017) (clarifying that the period is either 180 days or when the taxpayer's tax return is due, whichever is earlier); Treas. Reg. § 1031(k)-1(b) (2008).

172. I.R.C. § 1031(a)(3), (f) (2017). Consultation with and specific review of the NRD rules and regulations where each property is located must be done to ensure full compliance with local rules. All NRD information is located at <https://www.nrdnet.org/nrds/find-your-nrd> [<https://perma.cc/HKY7-NRBN>].

With the addition of a single word, the application of § 1031 of the Code transformed. Yet various sources define real property to include water rights, which are typically defined under state law. Further, Nebraska designates water rights and conservation to local NRDs, where CIAs are controlled and defined.

Under this Comment's examination, CIAs are considered real property. With qualification under the facts and circumstances of a transaction, an exchange of CIAs for other like-kind real property held for use in trade or business or for investment should receive § 1031 treatment. Applying this determination, any gain or loss realized through an exchange of CIAs should not be recognized. Therefore, any amount of gain or loss realized should be rolled into the replacement property and deferred until its sale, exchange, or other disposition. There is no limit to the number of exchanges this property can go through, leading to another important question: will gain or loss realized on the exchange of CIAs ever be recognized? The answer is no, if held until death.