Alert
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COZEN O'CONNOR

IRS Issues Final Regulations Governing 1031 Exchanges – The "Like Kind" Standard Defined

Introduction

On November 23, 2020, Treasury and the IRS issued final regulations governing tax-deferred exchanges of like-kind real property under Section 1031 of the Internal Revenue Code (the Code). These final regulations (T.D. 9935) address revisions to Code Section 1031 enacted as part of the Tax Cuts and Jobs Act (Pub. L. No. 115-97) of 2017 (the TCJA). As we acknowledged in our client alert at that time, the TCJA preserved tax-deferred exchanges of real property while eliminating personal property exchanges under the Code. Accordingly, the IRS sought to further define what constitutes real property for purposes of effectuating a tax-deferred exchange while providing additional guidance to taxpayers regarding incidental amounts of personal property that often accompany the exchange of real property assets, such as office buildings and hotels. What follows is a brief summary of a 75-page document, setting forth the highlights of the final regulations for "like-kind" real property under the Code. No matter one's view, the final regulations represent a step forward in providing certainty to taxpayers when exchanging similar but not identical real property assets.

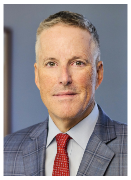
Background

Absent qualification under the like-kind exchange provisions of the Code, the transfer of one property in exchange for another produces the same tax consequences as an outright sale. The exception to recognition of gain is set forth in Code Section 1031(a)(1), providing that no gain is recognized on the exchange of property held for productive use in a trade or business or for investment if the property is exchanged by the same taxpayer solely for property of a like-kind that is to be held either for productive use in a trade or business or for investment.[1] A tax-deferred transaction is one in which, pursuant to an agreement with a qualifying third party (the QI), the taxpayer transfers relinquished property and subsequently receives replacement property. The transaction must fairly be characterized as an exchange and not a sale (i.e., a transfer of property for property, as distinguished from a transfer of property for money). The property exchanged (the relinquished property) and the property acquired (the replacement property) must each be "held for" trade, business, or investment purposes only, and "dealers" cannot take advantage of tax-deferred exchanges because they are considered to be in the business of purchase and sale rather than investment. The taxpayer must hold property for investment or for income production, or intend to use the property in her trade or business, to satisfy the "qualified use" standard.

Without Code Section 1031, a taxpayer would have to pay tax on a "paper gain" without actually receiving the cash to pay the tax. The increased wealth (i.e., gain) is still tied up in a continuing investment in the same type of asset. Where the exchange reflects both continuity of ownership and investment intent, nonrecognition treatment will be afforded the transaction. Qualifying assets are used in the taxpayer's trade or business. Before enactment of the TCJA, these assets included depreciable tangible and intangible personal property, and real property, whether or not depreciable. They include timber, certain livestock, and un-harvested crops that are transferred with the land. They did not include inventory or property held primarily for sale to customers in the ordinary course of the taxpayer's business. Following the TCJA, only real property assets qualify for Code Section 1031 tax-deferred exchanges, and these assets must be of a like-kind.

Like-Kind Real Property

At first blush, *like-kind* real property is easy to define: All real estate in the United States is like-kind property. Code Section 1031 makes no distinction in qualities of real estate. Therefore, a city



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lot is like-kind to farmland; and improved property is like-kind to a vacant lot.[2] Real estate located outside the United States (i.e., "foreign" real estate) is not like-kind to real estate in the 50 states, even if it is located in an affiliated commonwealth or territory, such as Puerto Rico.

Like-kind refers to the nature or character of the property and not to its grade or quality.[3] If the taxpayer's original investment is tied up in the exchanged-for property, even with considerably different characteristics, the IRS and the courts give lenient treatment to real property exchanges.[4] The IRS has historically given taxpayers wide latitude in the kinds of replacement properties that meet the like-kind standard, noting that the standard is one of a like — not an identical — kind.[5] Examples of these more esoteric like-kind properties include perpetual water rights,[6] a leasehold interest with 30 or more years to run,[7] certain easements and an undivided fractional interest in property as tenants-in-common. Accordingly, the properties exchanged must be of the same type, but they do not need to be of the same grade or quality. Real properties are generally of like-kind to all other properties, regardless of whether the properties are improved or unimproved.

The Final Regulations

As we previously reported, the TCJA, among other things, implemented statutory changes limiting gain recognition to like-kind exchanges of real property only. T.D. 9935 finalizes proposed regulations (REG-117589-18) published in the Federal Register on June 12, 2020, and do not present anything like a radical departure from past guidance. Rather, the regulations appear to codify the multitude of technical memoranda, chief counsel advice and private letter rulings and other authority issued by the IRS over the years, and court cases addressing what interests should be legally defined as constituting real property.

As a result, the final regulations generally provide that property is "real property" if, on the date of the exchange, that property is classified as real property under the law of the state in which that property is located, expressly adopting the "state and local law test" as determinative to the analysis. This emphasis is consistent with the chief counsel's directive to examiners in 2004, affirming that examiners should rely upon state law classifications of real property in reaching determinations as to the nature of property interests being exchanged under Code Section 1031.[8]

As explained in the preamble to the final regulations, real property includes land and improvements to land (defined as inherently permanent structures and structural components of inherently permanent structures), unsevered crops and other natural products of land, and water and air space superjacent to land. Real property also includes certain interests in real property, including leaseholds, easements, co-ownerships, and options to acquire real property, all consistent with prior regulation or guidance on the subjects. The highlights of the final regulations include the following:

Creation of a Distinct Asset Approach

In determining whether property is land or an improvement to land, each "distinct asset" described by the final regulations must be analyzed separately. The regulations provide certain items of property that are considered to be distinct assets. For property that is not specifically listed as a distinct asset, the regulations provide that a list of factors must be considered, and no one factor is determinative to the conclusion. Key to the analysis is the permanence of the asset: All inherently permanent structures include any building or other structure that is permanently affixed to real property and that will ordinarily remain affixed for an indefinite period of time. For this purpose, a "building" is defined as any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, parking, display, or sales space.

These rules are similar to the rules concerning distinct assets in Treasury Regulation Section 1.856-10(e), where real property is defined as land and improvements to land, and improvements to land refers to inherently permanent structures and their structural components. As noted there, buildings include the following distinct assets if permanently affixed: Houses; apartments; hotels; motels; enclosed stadiums and arenas; enclosed shopping malls; factory and office buildings; warehouses; barns; enclosed garages; enclosed transportation stations and terminals; and stores.

If permanently affixed to land or to its improvements, other inherently permanent structures include microwave transmission, cell, broadcast, and electrical transmission towers; telephone poles; parking facilities; bridges; tunnels; roadbeds; railroad tracks; transmission lines; pipelines; fences; in-ground swimming pools; offshore drilling platforms; storage structures such as silos and oil and gas storage tanks; and stationary wharves and docks. Accordingly, the final regulations governing like-kind exchanges provide a list of structures that qualify as inherently permanent structures. If property is not included in the list of inherently permanent structures, the analysis requires consideration of other factors to determine whether the property is an inherently permanent structure for purposes of Code Section 1031, and guidance is clearly provided by Treasury Regulation Section 1.856-10(d)(2)(iv)). Therefore, local law definitions are not controlling for purposes of determining whether an item of property is real property under Code Section 1031.

The distinct asset analysis of the like-kind regulations extends to structural components of an inherently permanent structure. A structural component is any distinct asset that is a constituent part of, and integrated into, an inherently permanent structure, such as embedded pipes in floors and walls that serve critical building systems. The preamble explains that a structural component may qualify as real property only if the taxpayer holds its interest in the structural component together with a real property interest within the physical space of the inherently permanent structure served by the structural component. Therefore, a gas line that provides fuel to a building's heating system is part of the structural component that is the heating system and, therefore, qualifies as real property. However, if the purpose of a gas line is to provide fuel to business equipment in a building (such as fryers and ovens in a building used as a restaurant where the fryers and ovens are movable personal property), the gas line is not a constituent part of an inherently permanent structure and therefore not real property. For components not included in the list, the final regulations provide factors for determining whether the component is a structural component of a building or inherently permanent structure and thus real property for Code Section 1031 purposes.

This analysis now also extends to machinery and equipment, typically movable, personal property by most commonly recognized definitions. The final regulations note that property that is in the nature of machinery or equipment is generally not an inherently permanent structure and not real property for Code Section 1031 purposes. However, in instances of a building or other inherently permanent structure that includes property in the nature of machinery as a structural component, the proposed regulations provide that machinery is real property if it serves the inherently permanent structure and does not produce or contribute to the production of income other than for the use or occupancy of space. Again, these rules regarding machinery adopt the rules in Treasury Regulation Sections 1.263A-8(c)(4) and 1.856-10(d)(iii). Machinery or equipment so integrated into the inherently permanent structure as to make it a structural component converts it into real property for Code Section 1031 purposes. The stand-alone auxiliary power generator located outside the premises of the building and installed on its own pad, even though conduit connecting the generator to the building's electrical system run through the foundation and floor of the building, would fail this test.

Adoption of a State and Local Law Test

While state law property classifications are relevant to the discussion of what constitutes real property, the IRS historically challenged exchanges by taking a "facts and circumstances" approach to the question of whether properties are of the same nature and character.[9] Accordingly, taxpayers faced a generally favorable but uncertain interpretation of like-kind exchanges. For example: Growing timber has been determined as both being like-kind to fee title[10] and as not being like-kind to fee title.[11] The facts and circumstances approach finds statutory expression in Treasury Regulation Section 1.856-10(d)(iv.) In its most recent iteration on the subject, the Chief Counsel Office expressed its opinion as to the primacy of federal, not state, law in determining like-kind eligibility status;[12] namely, while expressing support for the "state and local law test," the chief counsel stated that federal income tax law, *not* state law, controls whether exchanged properties are of like kind (Chief Counsel Advice 201238027). There, the chief counsel noted that, while state law property classifications are relevant for determining if property is real or personal property, such classifications are not determinative of whether properties are of the same nature and character and that such a determination could only be reached upon a totality of a facts and circumstances analysis.

To set aside the uncertainty created over whether the “state and local law test” or the “facts and circumstances test” would prevail, the final regulations do not adopt the reasoning of the Chief Counsel Advice to the extent it suggests that state or local law is disregarded in determining whether property is real property for purposes of Code Section 1031. Accordingly, and to taxpayers’ advantage, the final regulations have broadened the applicability of state and local real property classification and provide the first **bright-line test of its kind**: Property is real property, if, on the date it is transferred in an exchange, the property is classified as real property under the law of the state or local jurisdiction in which the property is located. To avoid the potential for conflict here, the final regulations make clear that a state law determination that property is personal rather than real property does not preclude the conclusion that property is real property if it is (a) specifically listed in Regs. Sec. 1.1031(a)-3(a)(2)(ii) (property being permanently affixed to the structure) or (b) Regs. Sec. 1.1031(a)-3(a)(2)(iii)(B) (defining structural components), or if it is specifically noted as real property under the facts and circumstances in (x) Regs. Sec. 1.1031(a)-3(a)(2)(ii)(C) (other inherently permanent structures) or (y) Regs. Sec. 1.1031(a)-3(a)(2)(iii)(B).

Rejection of a Purpose and Use Test

The final regulations dispose of a “purpose and use test” when determining eligibility of like-kind property. The proposed regulations would have disqualified tangible or intangible property as real property if such property was used in the production of income “unrelated to the use or occupancy of space” even if such property had a permanence about it, such as a structural component otherwise suggestive of eligibility as like-kind property. As such, equipment and machinery could have been excluded for exchange treatment based upon the purposes they serve the taxpayer even if they were permanently built on or affixed to the real property as a structural component, creating competing tests under the final regulations. Accordingly, the IRS will generally consider both tangible and intangible property to be real property if, on the transfer date, the controlling state or local jurisdiction classifies it as such.

The matter addresses the fact that equipment and machinery is generally not an inherently permanent structure and therefore not real property under Code Section 1031. However, in instances of a building or other inherently permanent structure that includes property in the nature of equipment or machinery as a structural component, the proposed regulations provided that machinery is real property if it serves the inherently permanent structure and does not produce or contribute to the production of income other than for the use or occupancy of space. The final regulations eliminates this arbitrary distinction and provides certainty regarding machinery that is so affixed and critical as a structural component to the qualifying asset that its removal would be infeasible.

Incidental Personal Property

Importantly, the final regulations create a safe harbor for a real property exchanges that includes up to 15 percent in personal property value as a percentage of the entire sale price. The concern that the sales price reflects a substantial valuation for personal property that could disqualify the entire exchange has been ameliorated by the express acknowledgement that, although acquisitions of personal property valued in excess of 15 percent of the replacement real property are not disregarded in applying the safe harbors, such acquisitions do not automatically cause the exchange to fail and the transfer of the relinquished property to be treated as a taxable sale. In short, when in standard commercial transactions the personal property is incidental to real property acquired in an exchange, and the aggregate fair market value of the incidental personal property transferred with the real property does not exceed 15 percent of the aggregate fair market value of the replacement real property, the IRS will recognize the transaction as qualifying for Code Section 1031 treatment. This “incidental property rule” is based on the existing rule in Treasury Regulation Section 1.1031(k)-1(c)(5), providing that certain incidental property is ignored in determining whether a taxpayer has properly identified replacement property under Code Section 1031(a)(3)(A) and Treasury Regulation Section 1.1031(k)-1(c). Without this safe harbor, many exchanges of large office buildings and hotel properties would fail for like-kind exchange treatment.

However, please take note of this important observation concerning the incidental property safe harbor: It does not make the “up to 15 percent” of personal property like-kind to the real property sold. Instead, the incidental property rule merely serves to treat that personal property as "boot" under Treasury Regulation Section 1.1031(k)-1(g)(7) and not as pre-mature receipt of boot violating Section1.1031(k)-1(g)(6), thereby invalidating the entire exchange. For example, if the taxpayer sells a hotel for $100 of real property and the QI is holding $100 but the taxpayer's replacement property is $92 real property plus $8 of personal property that is typically transferred with the real property, then if the QI funds the entire $100 for the purchase, the $8 will be boot and taxable, but the fact that the QI released $8 of exchange proceeds for non-like-kind property will not invalidate the entire exchange.

Summary

In short, the final regulations now define real property as:

1. Land and generally anything permanently built on or attached to land specifically identified in the final regulations;
2. Property that may not be specifically identified in the final regulations but, under state and local law, is characterized as real property;
3. Certain leasehold interests and easements; and
4. Incidental amounts of personal property included in the sale of qualifying real property and:
   a. the personal property is typically transferred together with the real property (for example, office furniture transferred with an office building); and
   b. the aggregate value of the personal does not exceed 15 percent of the aggregate fair market value of the replacement real property or properties received in the exchange.

Even if the particular item of property does not fall within categories (1)-(3), certain assets may be properly characterized as real property under the "all facts and circumstances" under the various factors set forth in the final regulations.

Effective Date

The final regulations are applicable for exchanges beginning after December 2, 2020. Taxpayers may rely on the proposed regulations (as published in the Federal Register on June 12, 2020) if they are followed consistently and in their entirety, for exchanges of real property beginning after December 31, 2017, and before December 2, 2020.

This summary only presents a high level overview of a 75-page submission by the Treasury Department. For more details, please contact the authors or visit https://www.irs.gov/newsroom/the-treasury-department-and-irs-issue-final-regulations-regarding-like-kind-exchanges-of-real-property and https://www.irs.gov/newsroom/tax-reform-guidance.

[1] Treasury Regulation Section 1.1031(k)-1(a).

[2] Treas. Regs. § 1.1031(a)-1(c).

[3] Treas. Reg. § 1.103(a)-1(b); *Commissioner v. Crichton*, 122 F.2d 181 (5th Cir. 1941).

[4] See *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260, 268 (1958); *Koch v. Commissioner*, 71 T.C. 54, 64 (1978); *TJ Starker v. U.S.*, 602 F.2d 1341 (1979); *CA Fed. Life Ins. v. Commissioner*, 680 F.2d 85, 87 (9th Cir. 1982).

[5] *Koch v. Commissioner*, 71 T.C. 54, 65 (1978).

6 Rev. Rul. 55-749; PLR 200404044.

[7] Treas. Reg. §1.1031(a)-1(c)(2).

[8] Field Service Advisory No. 2005-4101F (considering the issue of whether a crude oil pipeline was real or personal property under state law).

[9] See IRS C.C.A. 201238027 (April 17, 2012).

[10] *Oregon Lumber Co. v. Comm.*, 20 T.C. 192 (1953); TAM 9525002.

[11] *Smalley v. Comm.*, 116 T.C. No. 29 (2001). See also: PLR 200901020 (1-2-09) for a further discussion of property characterizations under state law.

[12] Chief Counsel Advice (CCA) 201238027 (April 17, 2012).