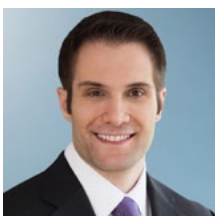
IRS FINALIZES 1031 REAL PROPERTY REGS: WHAT'S IN, WHAT'S OUT, AND WHAT TO DO

DAVID SHECHTMAN is senior counsel with Faegre Drinker Biddle & Reath LLP, in Philadelphia. He assists clients in capitalizing on the opportunities embedded in federal, state, and local tax laws. He helps clients navigate the tax aspects of mergers, acquisitions, and recapitalizations, and oversees administrative appeals of federal, state, and local tax controversies. David manages a national practice in the area of like-kind exchanges of real estate. In his capacity as counsel to taxpayers and various exchange intermediaries, he structures and documents hundreds of like-kind exchange transactions for major oil and gas, telecommunications, and transportation companies, as well as real estate investment trusts (REITs) and smaller real estate owners. His forms of exchange documents are widely used in the industry, and he has served as an expert witness in several lawsuits involving like-kind exchange issues. He is a thought leader on these exchanges and other tax topics and has been quoted frequently on tax issues in the Wall Street Journal and other business publications. He has spoken at all 24 national conferences on like-kind exchanges sponsored by the Center for Professional Seminars and Wells Fargo Exchange Services, as well as various programs sponsored by the ABA Tax Section, the Pennsylvania Bar Institute (PBI), and the NYU and USC Institutes on Federal Taxation.



MATT MELTZER is an associate with Faegre Drinker Biddle & Reath LLP, in Philadelphia. He works with private real estate businesses and publicly traded real estate investment trusts across the country in structuring like-kind exchanges of real estate. He also advises the intermediaries and lenders that facilitate the transaction. He has also served as special tax counsel in private securities offerings, including offerings of interests in Delaware statutory trusts intended to facilitate tax-deferred exchanges of real property, as well as in qualified opportunity fund investments. Matt also regularly assists both buyers and sellers in corporate acquisitions and mergers and joint ventures in drafting their agreements and navigating the complex world of tax diligence. Matt also has extensive experience in the field of state and local tax, with a focus on both transactions and addressing disputes. Recently, Matt has assisted a variety of businesses, particularly remote sellers, in navigating the new legal landscape of sales-and-use tax collection obligations and obtaining voluntary disclosure arrangements, both as a matter of routine compliance and to facilitate the closing of a business acquisition. He has also worked with real estate developers in structuring transactions in states and localities with intricate realty transfer tax schemes. Matt also litigates state and local tax disputes before administrative agencies and state appellate courts.

The law commonly known as the Tax Cuts and Jobs Act of 2017 (the TCJA) amended section 1031 of the Internal Revenue Code of 1986 (Code) to provide that only exchanges of like-kind *real* property are eligible for deferral of gain.[1] Following this amendment, the Department of the Treasury determined it was necessary to promulgate regulations establishing which assets qualify as real property under section 1031. Although case law and IRS guidance over the years occasionally have weighed in on the issue,[2] until recently Treasury had not articulated definitive rules for purposes of like-kind exchanges as it had done in the context of real estate investment trusts and cost recovery.[3]

On October 21, 2020, Treasury promulgated a final rule setting forth the definition of real property (the "real property regs" or "new regulations") for purposes of section 1031. In general, the real property regs provide that an asset is classified as real property for purposes of section 1031 if: (i) on the date it is transferred in an exchange, the asset is considered to be real property under the law of the state or local jurisdiction in which it is located; or (ii) if not so treated, the asset is specifically described in the new regulations or satisfies the new regulations' facts and circumstances test. Significantly, the new regulations establish that each asset is analyzed without regard to whether it contributes to the production of income unrelated to the use or occupancy of space.

This is an important (and taxpayer-friendly) change from the approach of the proposed regulations.

While the real property regs follow Congress' intent that real property eligible for like-kind exchange treatment under pre-TCJA law would continue to be eligible for like-kind exchange treatment under the amended provision,[4] they clarify the rules and thus provide taxpayers with a more specific roadmap for structuring their exchanges. Unsurprisingly, the new regulations provide that any form of property interest that was ineligible for like-kind exchange treatment prior to the enactment of the TCJA (e.g., partnership interests) will remain ineligible. The new regulations apply to like-kind exchanges that began after December 2, 2020.

This article analyzes the new regulations and recommends structures for exchanges involving both permitted real property interests and ineligible personal property items.

SUMMARY OF THE REAL PROPERTY REGS

Overview

The final rule creates a new section 1.1031(a)-3 of the Treasury Regulations that is devoted solely to the "definition of real property." In general, the real property regs define real property for purposes of section 1031 as land, improvements to land, unsevered natural products of land, and water and air space superadjacent to land.[5] The term "improvements to land" means "inherently permanent structures" and "the structural components of inherently permanent structures."[6] Property that constitutes real property under state and local law on the date the property is transferred in an exchange is real property for purposes of section 1031.[7] This is a change from the proposed regulations, which de-emphasized state law classifications.

Importantly, the real property regs are not intended to address whether exchanged properties are of like kind to each other; accordingly, whether real properties are of the same kind or class (versus grade or quality) still must be considered under the rules that existed before the passage of the TCJA.[8] The new regulations specifically state that they apply only for purposes of section 1031, and that no inference is intended with respect to the classification or characterization of property for any other purposes or provisions of the Code.[9]

Whether an "Inherently Permanent Structure" Qualifies as Real Property

The real property regs define an inherently permanent structure as any building or other structure that is a distinct asset and is permanently affixed to the real property and will ordinarily remain affixed for an indefinite period of time. A "distinct asset" is an asset that is analyzed separately from any other assets to which it relates to determine if it qualifies as real property, either as land, an inherently permanent structure, or a structural component of an inherently permanent structure, and typically includes such things as walls, plumbing systems, HVAC, elevators, and similar items.[10] "Affixation" is considered permanent if it is reasonably expected to last indefinitely based on all of the facts and circumstances.[11]

The new regulations list several examples of what constitutes an inherently permanent structure. If, however, a particular item is not listed, then the determination of whether it constitutes an inherently permanent structure is based on the following five factors:

1. The manner in which the distinct asset is affixed to the real property;
2. Whether the distinct asset is designed to be removed or to remain in place;
3. The damage that removal of the distinct asset would cause to the item itself or to the real property to which it is affixed;
4. Any circumstances that suggest the expected period of affixation is not indefinite; and
5. The time and expense required to move the distinct asset.[12]

Whether a "Structural Component" of an Inherently Permanent Structure Qualifies as Real Property

Similarly, the real property regs define a structural component of an inherently permanent structure as any distinct asset that is a constituent part of, and is integrated into, an inherently permanent structure.[13] For example, systems that provide a building with electricity, heat, or water would be analyzed together as one distinct asset that may constitute a structural component. Tenant improvements that become inherently permanent also may qualify as a structural component. 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 in the space in the inherently permanent structure that is served by the structural component.

DEALING WITH INCIDENTAL PERSONAL PROPERTY

Overview

As described above, the real property regs provide a taxpayer-friendly set of rules under which fixtures and other separately identifiable assets will qualify as real property for section 1031 purposes. Nevertheless, many transfers of apartment buildings, office buildings, hotels and similar properties will include assets that clearly are personal property. Often the parties will agree in their purchase and sale agreement to allocate a portion of the overall purchase price to personal property, possibly to minimize state realty transfer taxes and possibly to obtain increased depreciation deductions (including "bonus" depreciation) for the buyer. The remainder of this article addresses issues that may arise when a taxpayer engaging in a section 1031 exchange (an "exchange") disposes of, or acquires, personal property as part of a real property transaction, including the limited scope "incidental personal property" rule under the real property regs. We also discuss the impact of the new regulations on cost segregation studies.

Personal Property Carve Outs: Deferred Exchanges

In the authors' experience, many section 1031 qualified intermediary (QI) companies proffer one-size-fits-all exchange documents originally created shortly after one of the authors was born and unchanged since. Given that the TCJA causes all dispositions of personal property to be taxable, those exchange agreements should be revised to carve out rights with respect to personal property from the scope of assignments of relinquished property or replacement property purchase and sale agreements.[14] Suggested language for the assignment agreement (relinquished property) between an exchanger and a qualified intermediary where some of the purchase price is allocable to personal property follows:

> **Excluded assets.** Exchanger shall retain all rights and obligations under the Relinquished Property Sale Contract with respect to the personal property to be transferred to the Buyer (the "Excluded Assets") and shall receive directly from the Buyer that portion of the aggregate purchase price allocable to the Excluded Assets.

This carve out will enable the exchanger to receive funds that it can employ for business purposes rather than needlessly directing those funds to a qualified intermediary that cannot use those funds to acquire like-kind replacement property. A similar carve out for a replacement property assignment also should be considered. Although the real property regs create an "incidental property rule" which permits a qualified intermediary to use exchange funds for the purchase of non-qualified personal property (not exceeding 15 percent of the aggregate value of replacement real property), that rule does not eliminate "boot" treatment in a section 1031 exchange.[15] Rather, the rule merely insures that the qualified intermediary's use of exchange funds to acquire personal property during the 180-day period will not taint the entire exchange under the so-called "(g)(6) limitations" regarding use of exchange funds and constructive receipt.[16] The following examples demonstrate the incidental property rule; however, the crucial point is that "boot" treatment or even failure of the entire exchange can be avoided if the exchanger uses non-exchange funds to acquire personal property.

Example 1

Ben owns and has held for investment raw land known as Treyball. On May 1, 2021, Ben engages Joel as his qualified intermediary and disposes of Treyball to Tobias, a third-party buyer, who transfers $1 million to Joel's exchange account maintained for Ben's benefit pursuant to an exchange agreement. On June 11, 2021, Ben identifies two potential replacement properties for his exchange: (i) Turnover Apartments and (ii) Triple-Double Estates. The purchase and sale agreement for Turnover Apartments allocates $900,000 to real property (land and building) and $100,000 to personal property (washer, dryers, and furniture). On August 1, 2021, Ben acquires (through Joel as QI) Turnover Apartments and directs Joel to disburse all $1 million in exchange funds to Dwight, a third-party seller. Ben does not acquire Triple-Double Estates.

Ben's exchange complies with the incidental property rule because the value of the personal property he acquires with exchange funds is less than 15 percent of the value of the real property he acquires ($100,000 ÷ $900,00 = 11.11%). As a result, Ben's exchange does not violate the g(6) limitations and qualifies under section 1031. However, Ben has $100,000 of taxable boot because that amount of exchange funds were used to acquire non-like kind property.

Example 2

Same facts as Example 1, but the purchase and sale agreement allocates $860,000 to land and building and $140,000 to personal property. Ben's entire exchange fails, and he is taxed on all realized gain, because the amount of personal property he receives is greater than 15 percent of the value of the real property he receives ($140,000 ÷ $860,000 = 16.28%).

As this Example demonstrates, taxpayers must apply the incidental property rule by comparing the value of the personal property acquired to the value of the real property acquired, not to the total purchase price. Ben acquired personal property worth only 14 percent of the total purchase price in Example 2 ($140,000/ ÷ $1 million), but that is not the relevant test.

In addition, it should be noted that Ben's exchange in Example 2 fails to qualify for non-recognition treatment (in whole or in part) under section 1031 only because Ben identified two potential replacement properties. Had Ben identified only Turnover Apartments as his replacement property, he could have received taxable boot in any amount (i.e., greater than 15 percent of the value of real property received) because he would have received "all of the replacement property [he was] entitled to receive under the exchange agreement."[17] Taxpayers in Ben's situation might consider identifying Turnover Apartments and Triple-Double Estates as "alternative" replacement properties in order to avoid the result in Example 2.

Personal Property Carve Outs: Reverse Exchanges

In so-called reverse exchanges or "parking arrangements," an entity known as an exchange accommodation titleholder (EAT) acquires legal title to property which is "parked" until it will ultimately serve as a taxpayer's replacement property in a section 1031 exchange.[18] The same issues will arise in a reverse exchange, as in a "forward" exchange, if the purchase and sale agreement for the parked property allocates a portion of the purchase price to personal property. Indeed, the problem may be exacerbated because the EAT, unlike a qualified intermediary, must acquire legal title (or other "qualified indicia of ownership") to the parked property. Often the EAT forms a special purpose, single-member LLC (SMLLC) to hold such legal title and then completes the exchange by transferring all the membership interests in that SMLLC to the exchanger.[19]

The problem that can arise in such a structure is that the SMLLC may own personal property, the "deemed" transfer of which could give rise to taxable boot or, if the personal property value exceeds the 15 percent threshold, invalidate the entire exchange. This problem often cannot be resolved by separating the ownership of the personal and real property because an outside lender may insist that a single entity must hold all property to secure that entity's obligations to the lender. The authors suggest language such as the following for inclusion in the qualified exchange accommodation agreement and purchase and sale agreement assignment between the EAT and the exchanger to avoid this potential problem:

> **Ownership of tangible personal property.** For purposes of administrative convenience, EAT will acquire legal title to the Incidental TPP from Seller and hold title thereto as nominee for Exchanger outside the scope of the QEA Agreement. Exchanger shall pay directly to the Seller that portion of the purchase price under the Purchase Agreement allocable to the Incidental TPP and shall be deemed the owner of the Incidental TPP for all purposes, including federal and relevant state income tax purposes.

Cost Segregation Impact

Most practitioners are familiar with cost segregation studies, "the purpose of which is identifying personal property assets and separating out personal assets for cost recovery purposes."[20] As noted above, the real property regs contain a laundry list of examples, including many assets typically identified in a cost segregation study (e.g., wiring, plumbing systems, permanent wall and floor coverings, sprinkler and security systems), which will be treated as real property for section 1031 purposes.[21] Significantly, the new regulations clearly limit their scope to defining real property for section 1031 purposes and not for cost recovery, cost capitalization or other purposes. Accordingly, cost segregation studies remain a viable option for section 1031 replacement property although practitioners need to recognize that full tax benefits may not be available.

For example, assume Kyrie hires KD Consulting to perform a cost segregation study on an office building he acquired as a 1031 replacement property. Further assume that: (i) Kyrie sold his relinquished property (owned free and clear with no debt) for \$20 million and acquired his replacement property using all \$20 million of exchange funds plus \$5 million of additional cash; and (ii) KD Consulting discovers \$5 million of replacement property cost segregation assets (five-year or 15-year recovery property). Lastly, assume Kyrie had a basis of \$12 million in his relinquished property so that his basis in his replacement property equals \$17 million (\$12 million of carryover basis plus \$5 million of excess basis).[22]

Under the relevant rule, Kyrie must allocate his overall basis among the various items comprising his replacement property (i.e., land, 39-year building and five or 15-year recovery periods) in accordance with their respective fair market values.[23] Thus, Kyrie takes a basis of \$3,400,000 in his cost segregation property [(\$17 million ([total basis]) x \$5 million ÷ \$25 million ([fair market value of cost segregation property over total fair market value)]). However, because so-called "bonus depreciation" is limited to "excess basis" (i.e., the additional \$5 million cash Kyrie pays toward his replacement property), Kyrie can claim only \$1 million of bonus depreciation [(\$3,400,000 (total basis in cost segregation property) x \$5 million ÷ \$17 million ([total excess basis over total basis)]).[24]

Note also that to take advantage of bonus depreciation and five-year or 15-year recovery periods for his cost segregation property, Kyrie will need to make the opt-out election under Treas. Reg. section 1.168(i)-6(j) to treat both his exchanged basis and excess basis in his replacement property as new modified accelerated cost recovery system (MACRS) property. Kyrie also will need to consider Code section 1245 recapture issues when he decides to sell his replacement property.

CONCLUSION

The real property regs provide taxpayers with a greater degree of certainty regarding which assets qualify as real property for Code section 1031 purposes by adopting a generous standard under which most fixtures and structural components of buildings (including typical "cost segregation" items) will pass the test. Practitioners need to keep in mind, however, that real property interests still must satisfy the separate like-kind standard to obtain tax deferral on exchanges. When personal property is transferred with real property, practitioners need to take appropriate steps to minimize taxable boot or even possible disqualification of the entire exchange and be sure that their transaction documents adequately address these issues.

Notes

1 Pub. L. 115-97, 131 Stat. 2054 (Dec. 22, 2017), sec. 13303(c).

2 See, e.g., Peabody Nat. Res. Co. v. C.I.R., 126 T.C. 261 (2006) (coal supply contracts constituted real property interests under New Mexico law and were of like kind to a relinquished gold mine); C.I.R. v. Crichton, 122 F.2d 181 (5th Cir. 1941) (a mineral right is real property under Louisiana state law and thus of like kind to other real property); Aquilino v. U.S., 363 U.S. 509 (1960) (in the application of a federal revenue act, state law controls in determining the nature of the legal interest which the taxpayer had in the property).

3 See Treas. Regs. §§ 1.865-10 and 1.263(a)-3(b).

4 See H.R. Conf. Rept. 115-466, at p. 398 n.726.

5 Treas. Reg. § 1.1031(a)-3(a)(1).

6 Treas. Reg. § 1.1031(a)-3(a)(2)(i).

7 Treas. Reg. §Treas. Reg. § 1.1031(a)-3(a)(1) and (a)(6).

8 See Treas. Reg. § 1.1031(a)-1(b); compare Burkhard Inv. Co. v. U.S., 100 F.2d 642 (9th Cir. 1938) (commercial building is of like-kind to an unimproved lot) with VIP Indus. Inc. v. C.I.R., T.C. Memo. 2013-157 (leasehold of less than 30 years is not of like-kind to a fee interest).

9 Treas. Reg. § 1.1031(a)-3(a)(7).

10 Treas. Reg. § 1.1031(a)-3(a)(4) and – 3(a)(2)(iii)(B).

11 Treas. Reg. § 1.1031(a)-3(a)(2)(ii)(A). A building is an inherently permanent structure, as are a variety of other structures that become affixed to real property by weight alone. See Treas. Reg. § 1.1031(a)-3(a)(2)(ii)(B) and (C).

12 Treas. Reg. § 1.1031(a)-3(a)(2)(ii)(C).

13 Treas. Reg. § 1.1031(a)-3(2)(iii).

14 See Treas. Reg. § 1.1031(k)-1(g)(4)(iv) and (v) regarding the effect of assignments of purchase and sale agreements by taxpayer to a qualified intermediary.

15 See Treas. Reg. § 1.1031(k)-1(g)(8)(vi).

16 See Treas. Reg. § 1.1031(k)-1(g)(6).

17 See Treas. Reg. § 1.1031(k)-1(g)(6)(iii)(A).

18 See Rev. Proc. 2000-37, 2000-40 I.R.B. 308, as amended by Rev. Proc. 2004-51, 2004-33 I.R.B. 294.

19 PLR 200712013 confirms that such a membership interest transfer is treated as a transfer of the SMLLC's assets for section 1031 purposes.

20 See ASCSP Comments for Proposed Regulation 1.1031(a)-3 (8/6/2020).

21 Treas. Regs. § 1.1031(a)-3(a)(2)(iii)(B).

22 IRC section 1031(d).

23 Rev. Rul. 68-36, 1968-1 C.B. 357

24 See Treas. Regs. § 1.168(k)-2(g)(5).