



IRC § 1031 incidental personal property after the Tax Cuts and Jobs Act - by Lee Medinets

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The Tax Cuts and Jobs Act of 2017 (TCJA), PL 115-97 lowered some taxes. Most dramatically, corporate taxes were cut by 40%. However, reductions came with “revenue raisers” that helped offset lost revenue. IRC § 1031 tax-deferred like-kind exchanges of real property came perilously close to being a revenue raiser casualty. Those of us who work in any aspect of the real estate business should be grateful that did not happen. The other type of § 1031 transactions, Exchanges of personal property, were not so fortunate. Personal property § 1031 exchanges have been entirely eliminated from the tax code.

Loss of the ability to exchange personal property is a serious problem for many types of businesses. Real estate dependent businesses are among those that are most affected. For example, a restaurant owner moving from one location to another cannot exchange its equipment, franchise or liquor license at one location for similar assets at a new location. Depreciation on the equipment will have to be recaptured, and appreciation of the franchise and liquor license will have to be recognized.

There are some less obvious consequences for real property owners of eliminating personal property exchanges. Here is one:

A taxpayer exchanges an apartment building for another apartment building. The only items of personal property included in each building are refrigerators.

Treas. Reg. 1.1031(k)-1(c)(5) permits a taxpayer to skip formally identifying “incidental property,” i.e., property typically transferred together with a larger item where the aggregate fair market value of the incidental property does not exceed 15% of the larger item. Refrigerators are typically transferred along with the apartment house where they are used, and they are worth less than 15% of the value of the apartment house. Under the old law, there was no problem caused by a taxpayer failing to identify the refrigerators in that scenario. At worst, there could be a small amount of taxable “boot” created if, for example, the refrigerators in the relinquished property were worth more than the ones in the replacement property.

Under the new law, however, refrigerators may not be exchanged at all. What if §1031 exchange funds are used, in part, to acquire refrigerators in the replacement property? The identification rule in the (c)(5) regulation is no help. That rule cannot be used to ignore the consequence of buying non-like kind property. Colleagues have argued that using exchange funds to acquire refrigerators (or, let’s say installed medical equipment) might violate the restriction of Treas. Reg. 1.1031(k)-1(g)(6) against the taxpayer having use or benefit of money or other property (for non-exchange purposes) before the end of the Exchange period. If that were a valid concern, the entire exchange would fail.

My view is that there is no fundamental problem here. Treas. Reg. 1.1031(k)-1(g)(7)(ii) permits exchange funds to be used for:

Transactional items that relate ... to the acquisition of the replacement property and appear under

local standards in the typical closing statements as the responsibility of a buyer or seller (e.g., commissions, prorated taxes, recording or transfer taxes, and title company fees).

There is little doubt that incidental personal property included in the sale of real property, such as refrigerators, relate to the purchase of replacement property and constitute the kind of transactional items that appear on a typical closing statement. My view is based on experience with commercial real estate closings, although, there is no case or IRS ruling to prove the point.

There is, however, a modicum of proof that this position is correct given that no one seemed worried about this issue before the law changed. What if a taxpayer had sold a warehouse with no personal property and bought an apartment building with refrigerators? In that case, Treas. Reg. 1.1031(k)-1(c)(5) is no help to the taxpayer because the taxpayer could never have identified refrigerators as a replacement for real property. It appears that taxpayers and practitioners have been relying on incidental personal property qualifying as (g)(7)(ii) transactional items for a very long time.

For more information about how personal property could affect real estate transactions based on the Tax Cuts and Jobs Act and other important issues related to §1031 exchanges, register for the new 1031 zone blog at <http://1031zone.madison1031.com/>.

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