



Proposed Section 1031 regulations define ‘real property’ for purposes of like-kind exchanges - by Steve Brodsky

August 18, 2020 - Front Section

Steve Brodsky

The 2017 Tax Cuts and Jobs Act (TCJA) repealed like-kind exchanges (Section 1031) for all other types of property that are not real property. As a result of the changes introduced in the TCJA, exactly what is considered real property has taken on greater significance. In order to provide guidance on this matter, the IRS recently released proposed regulations defining “real property” under Section 1031 and clarifying that the receipt of certain incidental personal property in a Section 1031 exchange will not violate the qualified intermediary (QI) safe harbor rules. (Under the general rules of Section 1031, if money or other non-like-kind property, such as personal property, is received in the exchange, gain is recognized to the extent of the money and the fair market value of the non-like-kind property received to the extent of the realized gain on the transfer of the real property.) The proposed regulations provide extensive rules distinguishing real property from personal property while specifying that these rules apply only for purposes of Section 1031.

In the context of this comprehensive definition of “real property” for Section 1031 purposes, state and local law definitions of real property are not controlling. The preamble to the proposed regulations clarifies that they integrate certain aspects of other regulations defining real property for a number of IRC provisions, including Sections 48 (energy credit), 263(a) (capitalization), 263A, 856 (REITs), and 897 (withholding on dispositions of USRP Interests), but that the proposed regulations do not adopt a definition of real property from any one provision. Also, authority under those regimes might be relevant in the context of what constitutes real property under Section 1031.

Under the proposed regulations, real property includes land and improvements to land and water and air space superjacent to land. This is similar to the language in a variety of other regulations but includes necessary differences.

Improvements to land include inherently permanent structures and the structural components of inherently permanent structures. Under the proposed regulations, each distinct asset must be evaluated separately to determine if it is land, an inherently permanent structure or a structural component of an inherently permanent structure. Additionally, the proposed regulations now

categorize several specific items, assets and systems as distinct assets and provide factors for identifying other distinct assets.

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. The proposed regulations identify other structures that qualify as inherently permanent structures and provide factors that must be used to determine if other property is an inherently permanent structure. Property that is in the nature of machinery or is essentially an item of machinery or equipment is generally not an inherently permanent structure unless 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.

A building is any structure or edifice enclosing a space within its walls and covered by a roof to provide housing or shelter or to provide working, office, parking or retail space. Buildings also include several distinct assets if permanently affixed, such as houses, hotels, enclosed stadiums, shopping malls, factories, office buildings and warehouses. Other inherently permanent structures include in-ground swimming pools, roads, bridges, tunnels, paved parking areas and parking facilities.

Structural components of inherently permanent structures are improvements to land and, thus, are real property. A structural component is any distinct asset that is a constituent part of, and integrated into, an inherently permanent structure. If interconnected assets work together to serve an inherently permanent structure (for example, systems that provide a building with electricity, heat, or water), the assets are analyzed together as one distinct asset that may qualify as a structural component.

The proposed regulations list properties that are structural components and provide factors for determining whether other components are structural components. The proposed regulations also address tenant improvements to a building. In addition, they describe under what circumstances an intangible asset is real property or an interest in real property. In the context of a 1031 transaction, personal property that is incidental to replacement real property is disregarded in determining whether a taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by a qualified intermediary are expressly limited for purposes of the 1031 regulations.

These proposed regulations are significant since they now provide a framework for determining whether a particular property, or component of that property, constitutes real property for purposes of Section 1031, and thus, would mitigate uncertainties currently in existence concerning the definition of real property for purposes of Section 1031.

Steve Brodsky, CPA, JD, LL.M., is a director in the Real Estate Group at Marks Paneth LLP, New York, N.Y