



Proposed Regulations for 1031 Exchanges After TCJA

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Overview

- Example of Section 1031¹ exchange structure
- Revisions to Section 1031 by the TCJA
- Review of REG-117589-18 (the “**Proposed Regulations**”) covering the post-TCJA version of Section 1031
- Comments requested by the IRS in relation to the Proposed Regulations

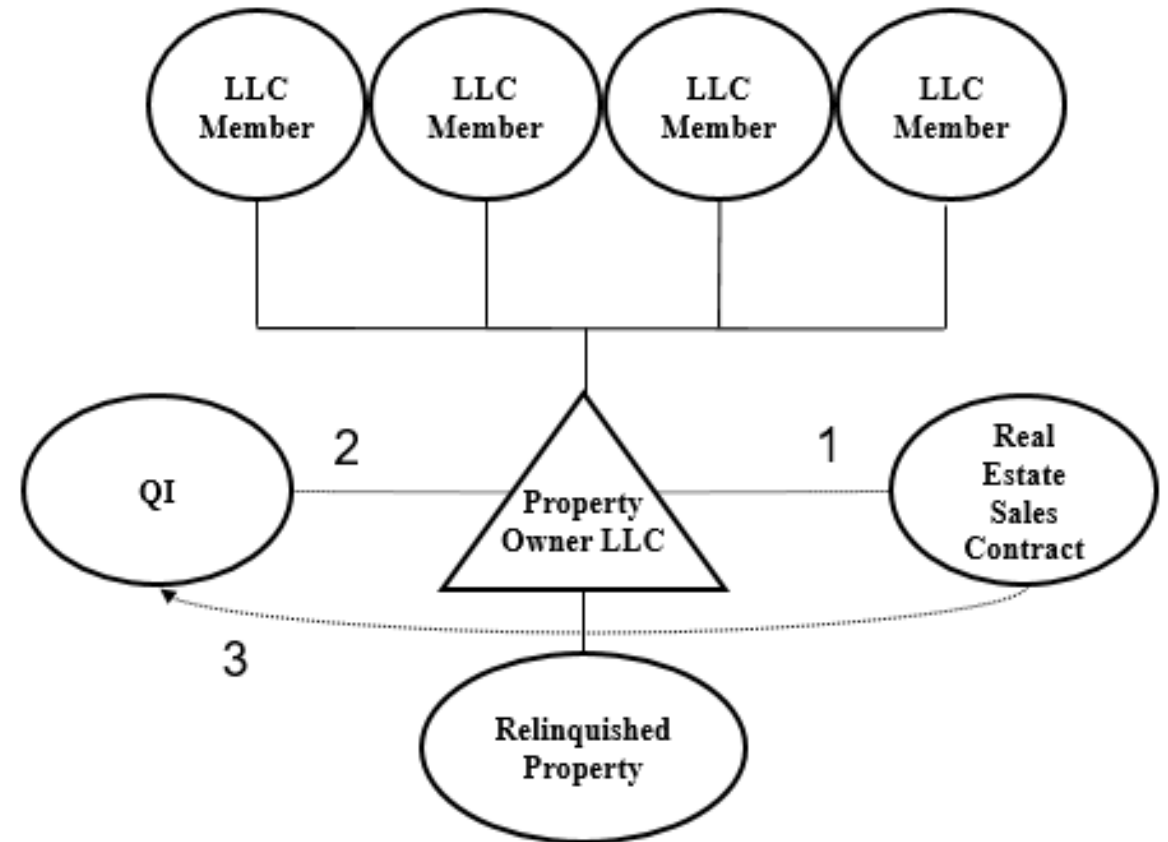
¹ Unless otherwise provided, all “Section” references are to the Internal Revenue Code of 1986, as amended.



1031 Exchange Structure

This example assumes that real property is being used in the 1031 exchange and that all of the members of Property Owner LLC have agreed to the 1031 exchange so that there will be no “drop-and-swap” of tenancy-in-common interests.

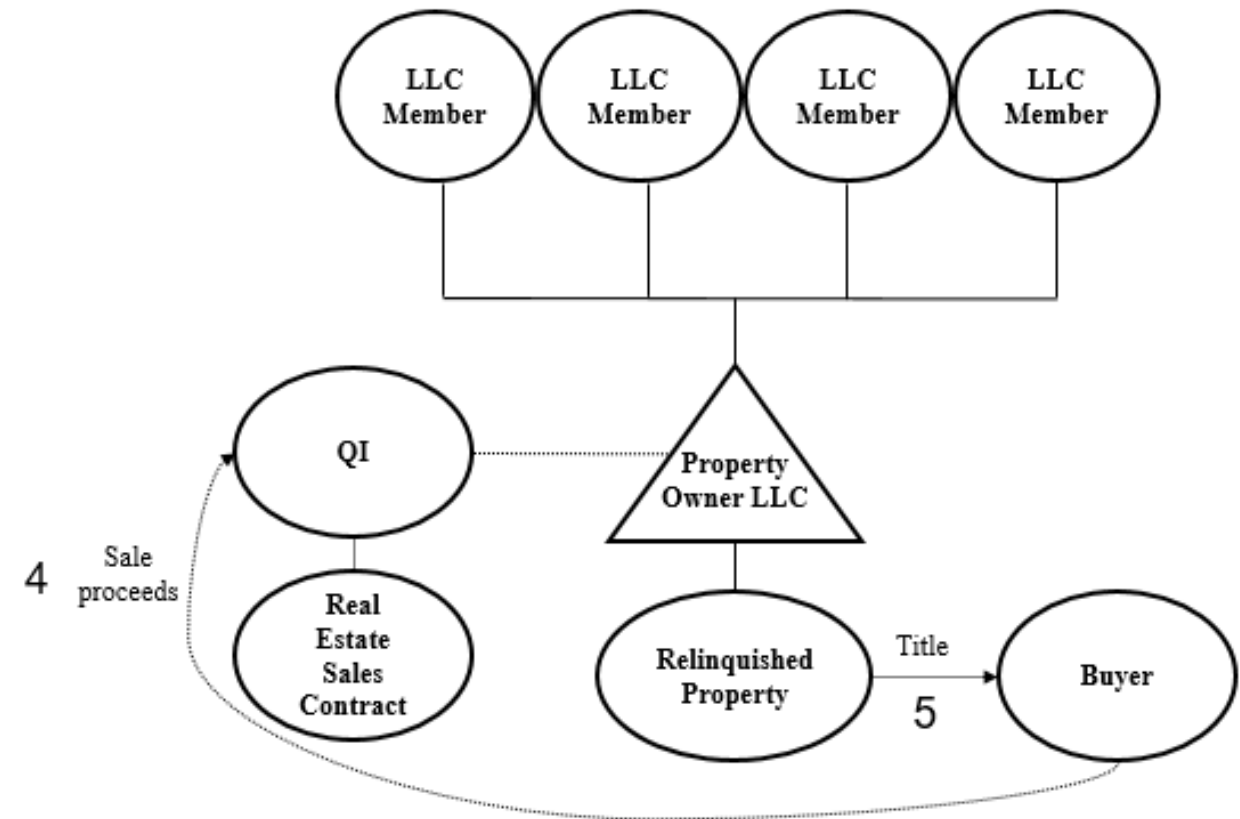
1. Property Owner LLC will enter into a real estate sales contract for the sale of its real property (the “**Relinquished Property**”).
2. Property Owner LLC will enter into an agreement with a “Qualified Intermediary” (“**QI**”) that will handle the proceeds throughout the 1031 exchange.
3. Property Owner LLC will assign the real estate sales contract for the Relinquished Property to the QI.



1031 Exchange Structure

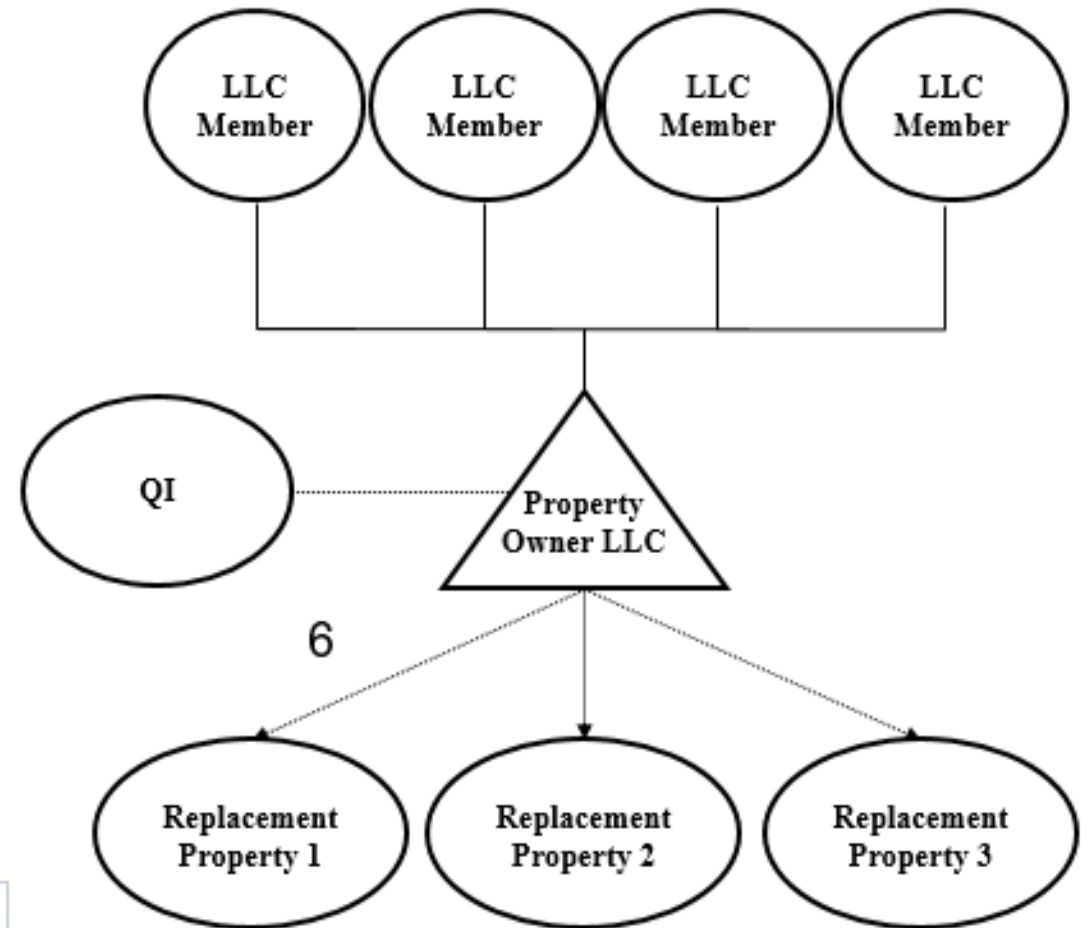
4. The Relinquished Property will be sold to the buyer, and the net sales proceeds from the closing on the sale of the Relinquished Property will be paid to the QI and will be deposited in a short-term account on behalf of Property Owner LLC.

5. Property Owner LLC will convey title of the Relinquished Property directly to the buyer.



1031 Exchange Structure

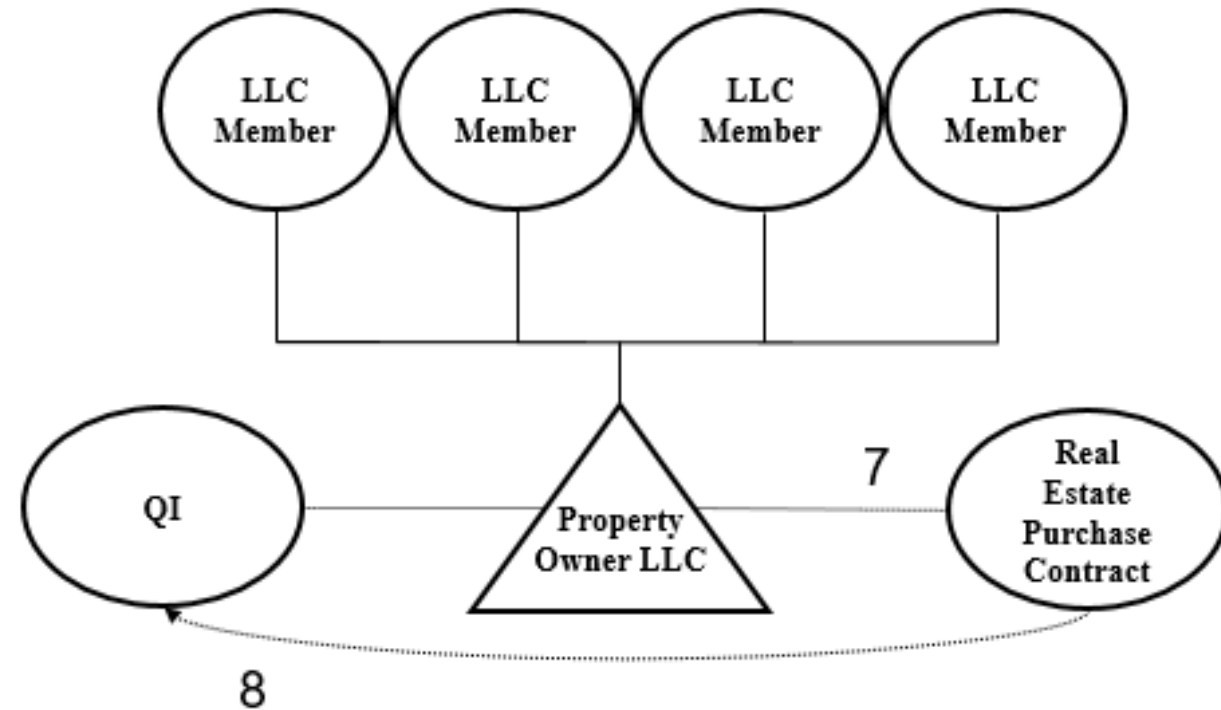
6. Property Owner LLC must identify in writing 3 replacement properties within 45 days from the date of sale of the Relinquished Property. In order to avoid boot and recognition of gain, the fair market value (both debt and equity) of the qualified replacement property must equal or exceed the fair market value (both debt and equity) of the Relinquished Property.



1031 Exchange Structure

7. Property Owner LLC will enter into a real estate purchase contract with the seller of the replacement property. We assume that Property Owner LLC has chosen Replacement Property 1.

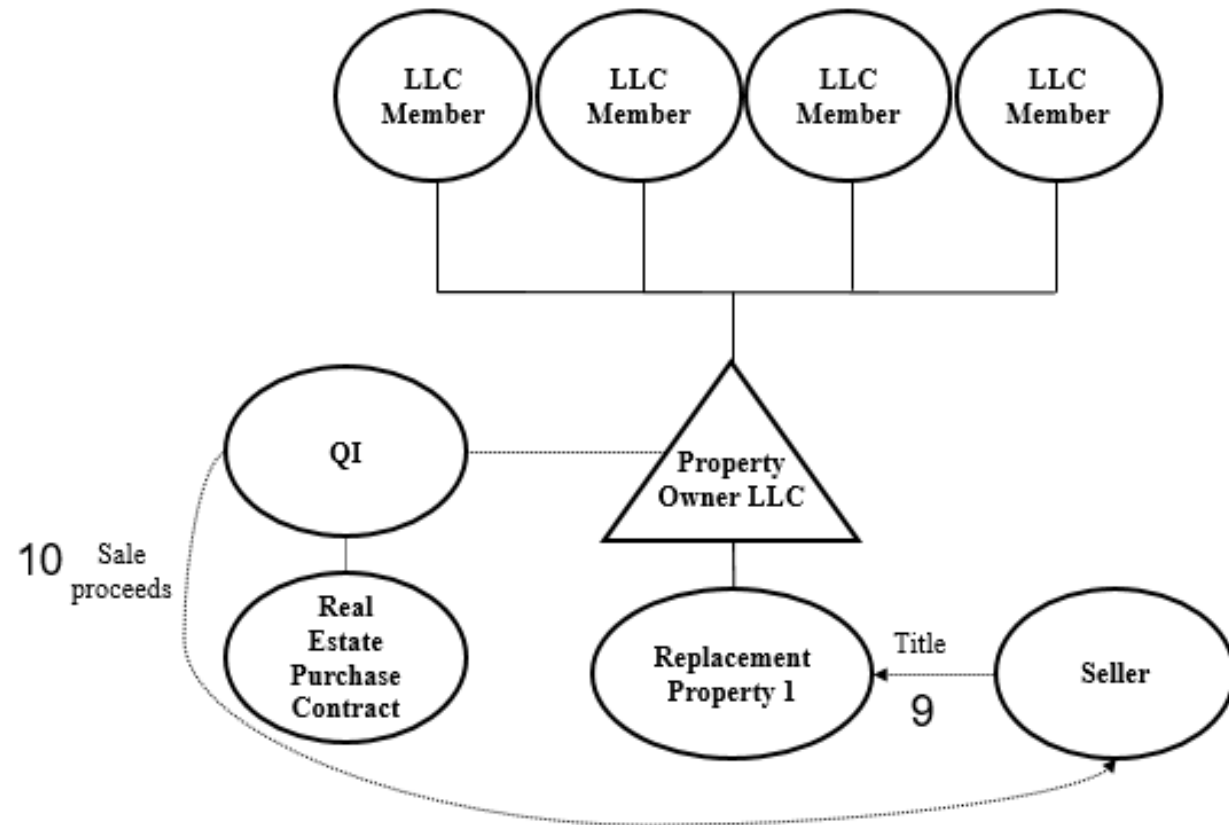
8. Property Owner LLC will assign the real estate purchase contract for Replacement Property 1 to the QI.



1031 Exchange Structure

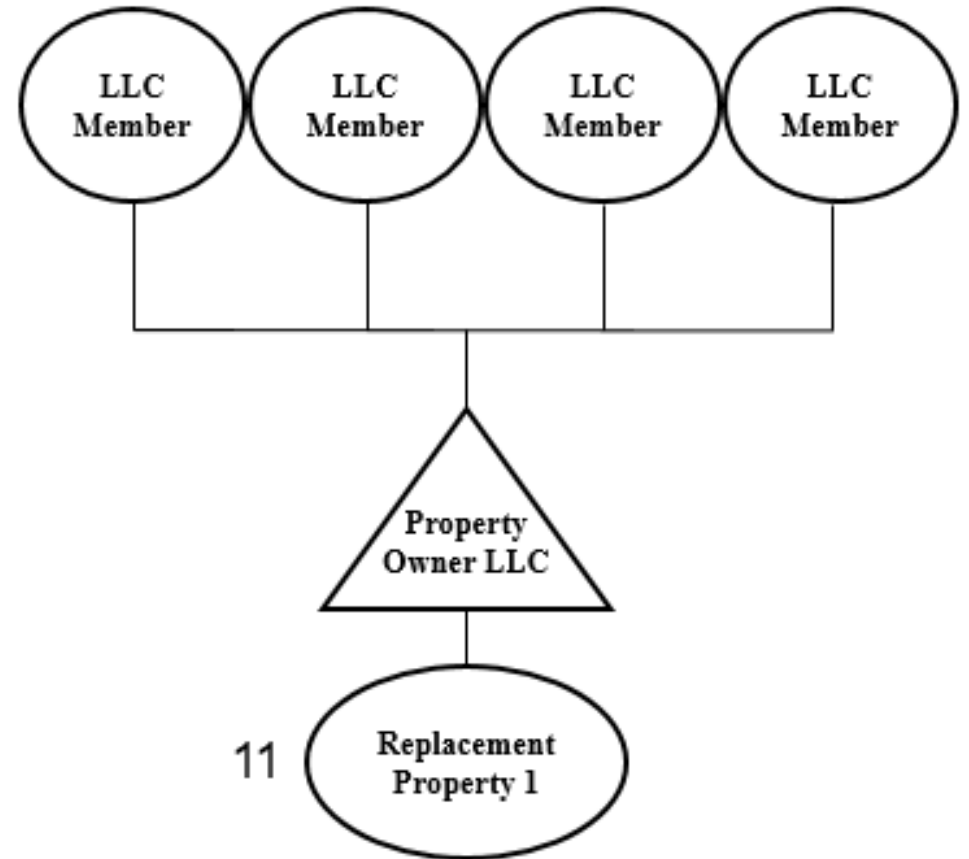
9. Property Owner LLC must close on the purchase of Replacement Property 1 within 180 days from the date of the sale of the Relinquished Property. At closing, the seller will convey the title of Replacement Property 1 directly to Property Owner LLC.

10. The QI will transfer the proceeds from the sale of the Relinquished Property to the seller of Replacement Property 1, and any remaining proceeds are transferred to Property Owner LLC.



1031 Exchange Structure

11. The end result would be that Property Owner LLC owns like-kind real property of equal or greater value to the Relinquished Property, and Property Owner LLC and its members would defer payment of capital gains tax.



Section 1031 Exchanges Under the TCJA

- The Tax Cuts and Jobs Act (the “**TCJA**”) amended Section 1031 as follows:
 - For exchanges completed after December 31, 2017, removed personal and certain intangible property from eligibility for like-kind exchange treatment so that Section 1031 is limited to exchanges of real property that is held for productive use in a trade or business, or for investment, and that is not held primarily for sale
 - Included a transition rule where the real property amendment did not apply to property disposed of by the taxpayer in an exchange on or before December 31, 2017, or property received by the taxpayer in an exchange on or before December 31, 2017



Proposed Regulations

- The Proposed Regulations apply to exchanges beginning on or after the date the regulations are published as final regulations in the Federal Register. However, a taxpayer may rely on the Proposed Regulations, if followed consistently and in their entirety, for exchanges of real property beginning after December 31, 2017, and before the final regulations are published.
- Comments and requests for a public hearing must be received by August 11, 2020.
- The Proposed Regulations cover the following:
 - Add a definition of real property in order to implement the statutory changes under the TCJA
 - Provide an incidental property exception to apply to a taxpayer's receipt of personal property that is incidental to real property the taxpayer receives in the 1031 exchange

Definition of Real Property

- Real property includes land and improvements to land (which include inherently permanent structures and the structural components of inherently permanent structures), unsevered crops and other natural products of land, and water and air space superjacent to land.
- In general, local law definitions are not controlling in determining the meaning of the term “real property” for purposes of Section 1031.
- Pre-TCJA real property rules that were carried over:
 - Real property under section 1031 includes shares in a mutual ditch, reservoir, or irrigation company described in section 501(c)(12)(A) of the Code if the state in which the company is organized views such shares as real property.
 - Real property eligible for like-kind exchange treatment before the TCJA continues to be eligible for like-kind exchange treatment under the amended Section 1031 (e.g., improved real estate and unimproved real estate are generally considered to be property of a like kind).
- “Water and air space superjacent to land” is not defined, but the Proposed Regulations provide boat slips as an example.

Distinct Assets

- Each distinct asset must be analyzed separately from any other assets to which the asset relates to determine if the asset is real property, whether as land, an inherently permanent structure, or a structural component of an inherently permanent structure.
- Items that are specifically listed in the Proposed Regulations as buildings and other inherently permanent structures are distinct assets.
- Assets and systems specifically listed in the Proposed Regulations as types of structural components also are treated as distinct assets.
- Other distinct assets are identified using the following factors:
 - (1) Whether the item is customarily sold or acquired as a single unit rather than as a component part of a larger asset;
 - (2) Whether the item can be separated from a larger asset, and if so, the cost of separating the item from the larger asset;
 - (3) Whether the item is commonly viewed as serving a useful function independent of a larger asset of which it is a part; and
 - (4) Whether separating the item from a larger asset of which it is a part impairs the functionality of the larger asset.

Inherently Permanent Structures

- The Proposed Regulations provide that 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, the Proposed Regulations define a “building” 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.
 - “Buildings” also 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.
- The Proposed Regulations also provide a list of structures that qualify as inherently permanent structures to include the following distinct assets, if permanently affixed:
 - in-ground swimming pools; roads; bridges; tunnels; paved parking areas, parking facilities, and other pavements; special foundations; stationary wharves and docks; fences; inherently permanent advertising displays for which an election under Section 1033(g)(3) is in effect; inherently permanent outdoor lighting facilities; railroad tracks and signals; telephone poles; power generation and transmission facilities; permanently installed telecommunications cables; microwave transmission, cell, broadcasting, and electric transmission towers; oil and gas pipelines; offshore drilling platforms, derricks, oil and gas storage tanks; grain storage bins and silos; and enclosed transportation stations and terminals.



Inherently Permanent Structures (cont.)

- If property is not included in the list of inherently permanent structures, the Proposed Regulations provide the following factors that must be used to determine whether the property is an inherently permanent structure for purposes of section 1031:
 - (1) The manner in which the distinct asset is affixed to 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.
- E.g., an indoor sculpture that is permanently affixed to a building

Structural Components of Inherently Permanent Structures

- 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.
 - E.g, a gas line that fuels a heating system is real property, whereas a gas line that fuels an oven is not real property
- 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.
- The Proposed Regulations also contain a list of properties that are structural components for purposes of Section 1031, provided the item is a constituent part of, and integrated into, an inherently permanent structure:
 - walls; partitions; doors; wiring; plumbing systems; central air conditioning and heating systems; pipes and ducts; elevators and escalators; floors; ceilings; permanent coverings of walls, floors, and ceilings; insulation; chimneys; fire suppression systems, including sprinkler systems and fire alarms; fire escapes; security systems; humidity control systems; and other similar property.



Structural Components of Inherently Permanent Structures (cont.)

- For components not included in the list, the Proposed Regulations provide the following factors for determining whether the component is a structural component of a building or inherently permanent structure and thus real property for Section 1031 purposes:
 - (1) The manner, time, and expense of installing and removing the component;
 - (2) Whether the component is designed to be moved;
 - (3) The damage that removal of the component would cause to the item itself or to the inherently permanent structure to which it is affixed; and
 - (4) Whether the component is installed during construction of the inherently permanent structure.
- Customization does not affect whether or not a distinct asset is a structural component.
- Tenant improvements to a building that are inherently permanent or otherwise classified as real property are real property for purposes of Section 1031.
- However, property produced for sale, such as bricks, nails, paint, and windowpanes, that is not real property in the hands of the producing taxpayer or a related person, but that may be incorporated into real property by an unrelated buyer, is not treated as real property by the producing taxpayer.

Machinery or Equipment

- Property that is in the nature of machinery or is essentially an item of machinery or equipment is generally not an inherently permanent structure and not real property under Section 1031.
- However, if a building or inherently permanent structure includes machinery as a structural component, the 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.
 - E.g, a 3D printer that manufactures products for the production of income other than for the use or occupancy of space is not real property, but an electrical generator that serves the entire building is real property

Unsevered Natural Products

- Unsevered natural products of land are generally treated as real property under Section 1031.
- Includes the following:
 - Growing crops, plants, and timber
 - Mines
 - Wells
 - Other natural deposits
- Natural products and deposits, such as crops, timber, water, ores, and minerals, cease to be real property when they are severed, extracted, or removed from the land (e.g., storing a harvested crop on real property does not cause it to be real property).

Intangible Property

- An intangible asset is real property or an interest in real property for purposes of Section 1031 to the extent it derives its value from real property or an interest in real property, is inseparable from that real property or interest in real property, and does not produce or contribute to the production of income other than consideration for the use or occupancy of space.
 - A license, permit, or other similar right that is solely for the use, enjoyment, or occupation of land or an inherently permanent structure, and that is in the nature of a leasehold, easement, or fee ownership, generally is an interest in real property for purposes of Section 1031 (e.g., mineral rights, coal supply contracts, and a leasehold interest in a producing oil lease).
- A license or permit to engage in or operate a business on real property is not real property or an interest in real property for purposes of Section 1031 if the license or permit produces or contributes to the production of income other than consideration for the use and occupancy of space.
 - E.g., casino license or liquor license

Incidental Personal Property

- Incidental personal property will not jeopardize a 1031 exchange, but incidental personal property is not part of the real property which qualifies for gain deferral.
- Personal property is incidental to real property acquired in an exchange if:
 - (1) in standard commercial transactions, the personal property is typically transferred together with the real property (e.g., hotels and office buildings), and
 - (2) the aggregate fair market value of the incidental personal property transferred with the real property does not exceed 15% of the aggregate fair market value of the replacement real property.

Comments Requested

- The IRS has requested comments on the following topics:
 - Whether the function of a distinct asset that is not machinery is appropriate to use as the basis for determining whether the asset qualifies as real property for Section 1031 purposes
 - Comments regarding the proposed relevant factors and analysis for determining the qualification of an item as real property
 - Comments regarding the proposed treatment of a taxpayer's receipt of personal property that is incidental to the taxpayer's replacement real property in an intended Section 1031 exchange
 - Comments regarding the two-factor analysis for determining whether personal property is incidental to real property acquired in such an exchange (especially the 15% fair market value limit)
 - Whether existing regulations under Section 1031 that apply to tax years before the TCJA amendments limiting its application to exchanges of real property should be removed



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