

Real Property Defined for Section 1031 Like-Kind Exchanges

The IRS issued Final Regulations, TD 9935, effective Dec 2, 2020, that provide guidance regarding the definition of real property for Section 1031 like-kind exchange purposes. The 2017 Tax Cuts & Jobs Act (TCJA) amended §1031 by limiting its application to real property, but the legislative intent was that real property that qualified for like-kind exchange treatment prior to the TCJA, would continue to qualify post-TCJA.

Definition of Real Property

The Final Regulations added new Treasury Regulation §1.1031(a)-3 defining real property for purposes of §1031. The new section clarifies that property defined as real property under state law is real property for purposes of §1031. Real property includes land and improvements to land, unsevered natural products of land, and water and air space superjacent to land. Classification of property for depreciation purposes does not impact the asset's character as real property under §1031.

Improvements are further defined as inherently permanent structures, or structural components thereof.

Improvements include buildings, enclosed parking facilities as well as paved parking areas, in-ground swimming pools, stationary wharves and docks, permanent advertising displays, power generation and transmission facilities, permanently installed telecommunications cables, microwave transmission, cell, broadcast and electric transmission towers, oil and gas pipelines, offshore platforms, derricks, oil and gas storage tanks, grain storage bins and silos, among other listed structures. For assets not specifically listed, there are 5 factors to be considered in making a determination:

1. The manner in which the asset is affixed to real property;
2. Whether designed to be permanent or removable;
3. Damage that removal would cause either to the asset or the real property;
4. Circumstances suggesting that the asset is not intended to be indefinitely affixed;
5. Time and expense required to move the asset.

Based upon the above analysis, bus shelters, which are easily removed and reinstalled elsewhere when routes change, do not qualify as inherently permanent structures, and would not qualify as real property under §1031. Conversely, a large sculpture constructed within a building's atrium, weighing five tons, which is permanently affixed to the building through specially designed structural supports, and which could not be removed without great cost and severe damage to both the sculpture and the building, would meet this test, and would qualify as real property.

Structural components include distinct assets that are a constituent part of and are integrated into an inherently permanent structure, such as wall, partitions, doors, wiring, plumbing and HVAC systems, piping and other components. For items not specifically listed, the factors to be considered are:

1. The manner, time and expense of installing and removing;
2. Whether the component is designed to be moved;
3. Damage that removal would cause to the component or the structure;
4. Whether it was installed during construction of the inherently permanent structure.

Unsevered natural products of land include growing crops, plants, and timber; mines; wells and other natural deposits, such as water, ores and minerals. These items lose their real property designation once they are severed, extracted or removed.

Intangibles that are treated as real property under §1031 include fee ownership; co-ownership, leaseholds, options to acquire real property, easements, stock in a cooperative housing corporation, shares in a mutual ditch, reservoir, or irrigation company that is treated as real estate under state law, and land development rights. Licenses and permits in the nature of a leasehold, easement or similar right, that are solely for the use, enjoyment or occupation of the land or permanent structure are also deemed to be real property. Thus a land use permit for a cell tower on land would qualify as real property, but a business license to operate a casino in a building would not.

The Final Regulations confirm that intangibles that were previously excluded under IRC §1031(a)(2), repealed in the TCJA, continue to be excluded, regardless of classification under state law. These non-qualifying assets include stock, bonds, notes, securities, debt instruments, partnership interests, certificates of trust or beneficial interest, and choses in action.

Real Property Defined for Section 1031 Like-Kind Exchanges (CONT.)

Incidental Personal Property is addressed in new Treasury Regulation §1.1031(k)-1(g)(7)(iii), which clarifies that use of exchange funds to acquire a small amount of personal property, incidental to the acquisition of real property, will not be deemed to be a violation of the safe harbor restrictions limiting the taxpayer's rights to receive, pledge, borrow or obtain the benefits of the exchange funds prior to receipt of like-kind property or an exchange terminating event. However, for the exception to apply, 1) the personal property must typically be transferred together with the real property in standard commercial transactions, and 2) the aggregate fair market value of the personal property must not exceed 15% of the aggregate fair market value of the replacement real property. If multiple replacement properties are acquired, the 15% threshold is measured against the total value of all replacement properties.

Importantly, the incidental property is disregarded only for purposes of determining whether there has been an early distribution of funds; it is not disregarded for purposes of determining like-kind property. Gain (or "boot") will still be recognized on the value of the incidental property acquired.