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Proposed Section 1031 Regulations Define Real Property and Address a Related Technical Issue

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On June 12, 2020, the IRS proposed new regulations[1] to implement changes made to I.R.C. section 1031 by the 2017 legislation commonly known as the Tax Cuts and Jobs Act ("TCJA").

In general, under section 1031, a taxpayer may defer recognition of gain (and thereby payment of tax) on certain exchanges of property for other property of "like kind." The TCJA removed exchanges of personal property from the ambit of section 1031, thereby limiting tax-deferred exchanges to real property. The proposed regulations define "real property" for purposes of section 1031. The proposed regulations also resolve a potential technical problem that the TCJA created in the case of the many exchanges of real property that also include some amount of incidental personal property.

I. Definition of Real Property and Like Kind

A. General Principles and Comparisons to Other Definitions

According to the preamble to the proposed regulations, their intent is generally to preserve (rather than to change) the definition of real property that has hitherto applied for section 1031 purposes, a definition that the preamble and the proposed regulations themselves indicate is "broader" than the definition that applies for other income tax purposes, including calculation of depreciation deductions. Thus, for example, some assets that the taxpayer has depreciated under rules applicable to personal property may still be eligible to be exchanged under section 1031 as real property, and some assets acquired as replacement property in a section 1031 exchange may be depreciated thereafter under the personal property rules. However, Taxpayers must be mindful of the depreciation recapture rules, which continue to apply, and which are of increased relevance in the era of 100% "bonus" depreciation.

By defining real property for section 1031 purposes, the IRS has implicitly provided a (negative) definition of personal property as well. That definition controls for all section 1031 purposes, including the incidental personal property safe harbor discussed below.

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[1] REG–117589–18 (85 Fed. Reg. 35,835).

B. Interests in Real Property

The proposed regulations tell us that an "interest in real property" (which is apparently treated as real property for purposes of section 1031) includes "fee ownership, co-ownership, a leasehold, an option to acquire real property, an easement, or a similar interest." The nature of an interest in real property is relevant for purposes of the like kind requirement discussed below.

It is surprising that this definition expressly includes options but does not address contracts. Under an option to acquire real property, only the seller is compelled; the buyer may exercise the option or not. However, under a contract to acquire real property, both the buyer and the seller are compelled to consummate the transaction. A contract, therefore, would seem "closer" to an interest in real property than an option. One distinction may be that contracts are often subject to contingencies to consummate, whereas options are often not. However, one could imagine a contract where a seller's only opportunity to "walk away" without consequence was the purchaser's failure to close on the day set forth in the contract. It is therefore unclear why the IRS included options but gave no guidance on whether contracts can ever qualify as interests in real property.

C. Real Property

The proposed regulations adopt for section 1031 purposes a standard similar, but not identical, to the definition of "real property" that applies under the rules for real estate investment trusts ("REITs), with some text apparently lifted verbatim.

In general, the proposed regulations categorize real property into: (1) land; (2) improvements to land; (3) certain intangibles; (4) "water and air space superjacent to land"; and (5) unsevered natural products of land (such as crops and minerals).

Improvements are subcategorized into (a) inherently permanent structures (such as buildings) and (b) structural components of inherently permanent structures. The general approach to analyzing improvements is to divide them into their smallest discrete units, known as "distinct assets," and then to determine whether each distinct asset is real property. Helpfully, the proposed regulations give laundry lists of *per se* distinct assets that are real property (among many others: houses, motels, enclosed shopping malls, bridges, fences) so long as those assets are permanently affixed to real property. For assets that are not *per se* real property, there are facts-and-circumstances tests (separate for inherently permanent structures and for structural components).

An intangible is real property for these purposes "[i] to the extent [it] derives its value from real property or an interest in real property, [ii] is inseparable from that real property or interest in real property, and [iii] does not produce or contribute to the production of income other than consideration for the use or occupancy of space." Expressly included in this definition are licenses and permits for the "use, enjoyment, or occupation" of real property, *but not* licenses and permits to "operate a business" on real property (e.g., a casino license).

The proposed regulations do not directly address development rights that are transferable separately from real property or from an interest in real property. For example, in certain municipalities, when a land owner has not built a building to its maximum legal size, that land owner may sell the unused

portion of those development rights to a purchaser who would then be entitled to construct a larger building on land owned by the purchaser. It is unclear if those rights would be intangibles that are treated as real property for these purposes, as they seem not to be "inseparable" from the land. However, arguably, those rights are "air space superjacent to land," and, therefore, real property for these purposes. Additionally, at least some of those rights were eligible to be exchanged with (other) real property prior to the TCJA, and, as stated above, a guiding principle of the proposed regulations was to preserve the eligibility of real property that could be exchanged prior to the TCJA. However, as the proposed regulations do not define "water and air space superjacent to land" or even of "superjacent," the answer is not certain.[2]

D. No Apparent Change to Like Kind Definition

There is no operative language in the proposed regulations that modifies or otherwise addresses the existing definition of "like kind" in the regulations.

The scope of what real property is like kind to other real property was and continues to be broad: Vacant land, an office building, a residential condominium unit, and perpetual mineral rights are all like kind to one another. However, authority and guidance often distinguish between types of *interests in real property*. A longstanding example in the regulations treats a leasehold in one property with 30 years remaining as like kind to a fee interest in another property.[3] However, cases have held that a leasehold with as much as 25 years remaining (including renewal periods) is not like kind to a fee interest. (Query whether a leasehold with 28 years or 29 years remaining would be like kind to a leasehold with 30 years remaining.)

Taxpayers must be cautious not to assume that everything that under the proposed regulations is (an interest in) real property could be exchanged with any other property that is (an interest in) real property for these purposes. The preamble to the proposed regulations underscores this by expressly reminding taxpayers that the like-kind requirement continues to apply. For example, all leaseholds are apparently interests in real property under the proposed regulations, but, as explained above, they are apparently not all like kind to other interests in real property (or even necessarily to other leaseholds).

Similarly, in the case of an option, it is not clear what other (interests in) real property would be like kind. Perhaps options are of like kind only to other options, or only to options in the same kind of property (farmland, warehouse, etc.). However, given the general wide range of like-kind treatment of real property, the intended answer is likely not so restrictive.

II. Mixed Exchanges of Real Property and Personal Property

Most taxpayers engage in exchanges under a safe harbor in the existing regulations that involves use of a "qualified intermediary" ("QI"). One of the requirements of that safe harbor is that a QI generally may not use funds it holds on behalf of a taxpayer for any purpose other than the acquisition of qualified replacement property. Since enactment of the TCJA, it has been unclear if the safe harbor was

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[2] In the case of water (but not air) there is one example (more or less borrowed from the REIT regulations), which states that "boat slips . . . are water space *super*jacent to land and thus are real property" (emphasis added) for purposes of section 1031. Query whether boat slips are *ad*jacent, rather than *super*jacent, to land.

[3] The example actually says that this leasehold is like kind to "real estate," but practitioners generally understand this to mean a fee interest and other property that is like kind to a fee interest.

violated by a QI's acquisition of personal property incident to the acquisition of real property (such as lobby furniture).[4] The proposed regulations revise the safe harbor, so that a QI may acquire incidental personal property comprising up to 15% of the value of all property acquired without violating the safe harbor.

Even under this change to the safe harbor, a taxpayer must recognize gain on the personal property portion of the exchange. For example, if a taxpayer exchanges real property worth $100 for real property worth $90 and incidental personal property worth $10, the taxpayer has received $10 of taxable "boot" on the exchange. The technical clarification above prevents only the recognition of *all* of the gain on the real property due to a possible violation of the QI safe harbor.

There remain open questions about the manner in which existing multi-asset exchange regulations (which cover mixed real-and-personal-property exchanges) continue to apply. For example, suppose a taxpayer exchanges real property worth $85 and incidental personal property worth $15 for real property worth $85 and incidental personal property worth $15. It is not clear if the taxpayer recognizes gain only with respect to the personal property exchanged, or also with respect to a portion of the real property exchanged (as a portion of the real property may be considered to be exchanged for personal property, which is not like kind to real property). Additionally, it is not clear to what extent gain on the exchange of incidental personal property that is not subject to depreciation recapture and that straddles tax years may be deferred under the installment method (which is largely the case for real property).

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If you have any questions about how these proposed regulations are likely to affect your individual situation, or section 1031 exchanges generally, please contact:

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[4] This issue existed with respect to certain pre-TCJA exchanges as well (e.g., in the case of land exchanged for land, building, and incidental personal property).