

## Summary of Final Regulations Defining Real Property and Modifying (g)(7) Items

On November 23, 2020, the IRS issued the final regulations defining real property for Section 1031 purposes. The regulations also contain a provision allowing a QI to use exchange proceeds to pay for personal property that is incidental to replacement real property without impacting the QI safe harbor.

**Changes from Proposed Regulations.** The final regulations make two significant changes to the definition of real property that was contained in the proposed regulations, issued in June 2020. First, the proposed regulations provided that state or local law was not controlling on the definition of real property, but final regulations reverse this and provide that state or local law can be used to classify a property as real property for Section 1031 purposes.

Second, the proposed regulations provided that structural components and machinery were not real property if they were used in the production of income. The proposed regulations contained examples providing that a 3D printer, an electrical generator and steam turbine were not real property because they were machinery and were used for the generation of income. This use test was a departure from the history of Section 1031, which treats income generating and investment property the same. The final regulations abandon this use test, and they provide that an asset is determined to be real or personal property based on the three tests described below, and not on its use. The same examples in the final regulations now provide that the 3D printer, electrical generator and steam turbine are real property under Section 1031 because of their state law classification or because they are permanently affixed. However, they must still be *like-kind* to the other real property in the exchange, as discussed below.

**Real Property Definition for Section 1031.** The regulations do not change pre-existing law on the determination of what is real property, and they will not impact most of exchanges. What is typically considered real property, such as land with a building, is defined as real property in the regulations. However, there are some assets that have both real and personal property characteristics, and they must be classified as one or the other to determine if they are exchangeable under Section 1031. The regulations provide three alternative tests to determine if a property is real property under Section 1031 purposes, which we will refer to as:

- (1) the State Law Test;
- (2) the Listed Assets Test; or
- (3) the Factors Test.

A property must only satisfy one of the three tests to qualify as real property. Thus, if it fails the State Law Test, it can still qualify under the Listed Assets Test or the Factors Test. Therefore, a taxpayer has several avenues to classify an asset as real property.

**State Law Test.** Under the regulations, property is real property for Section 1031 purposes if, on the date it is transferred in an exchange, the property is real property under the state or local law in which the property is located. The State Law Test gives a taxpayer an easy default rule to

determine whether an asset is real property. It will help with fixtures, machinery-like components, and other assets that have personal property characteristics, such as above-ground irrigation equipment. An asset may be real property in some states and personal in others, but the law of the property situs controls. An asset may also be real property for one purpose (e.g. property taxes) and personal for another (e.g. liens) under the same state's laws. The regulations do not give guidance on what to do in that situation, but the taxpayer could use one of the other tests to make the determination. If an asset is personal property under state law, it can still qualify as real property for Section 1031 purposes under the other two tests.

**The Listed Assets Test and Factors Test.** Land is always real property. An improvement on land is real property if it is either: (i) an inherently permanent structure; or (ii) a structural component thereof. The regulations contain separate lists of assets for structures and components. An asset qualifies as real property if it is a Listed Asset. If the asset is not a Listed Asset, then it can still satisfy the Factors Test for structures or components.

**(i) Inherently permanent structures.** Real property includes any building or other structure if it is permanently affixed to real property, and it will ordinarily remain affixed for an indefinite period of time. The regulations add that affixation is considered permanent if it is reasonably expected to last indefinitely based on all the facts and circumstances. The Listed Assets for structures include typical structures such as buildings and parking lots, as well as atypical items such as stationary wharves and docks, permanently installed cell, broadcasting, and electric transmission towers; oil and gas pipelines; and offshore platforms.

If a structure is not a Listed Asset, then it can be identified as real property using the Factors Test, which examines: (1) The manner in which the structure is affixed to real property (and affixation may be accomplished by weight alone); (2) Whether the structure is designed to be removed or to remain in place; (3) The damage that removal of the structure would cause to the structure 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 structure.

The regulations contain an example of a sculpture built-in to the atrium of a building. The sculpture is deemed to be a real property structure under the Factors Test because it cannot be removed without damaging the sculpture or the building. The regulations also contain an example of moveable bus shelters that are bolted to the ground. Based on the Factors, the shelters do not qualify as real property because they can be moved in less than a day without damage to the shelter or ground.

**(ii) Structural components.** Structural components are integrated into the inherently permanent structure. Interconnected assets that work together to serve a structure can be analyzed as one structural component, such as systems that provide electricity, heat or water. The Listed Components include 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.

If a component is not specifically listed in the regulations, then it is identified as real property using a Factors Test similar to that for structures: (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 component itself or to the structure to which it is affixed; and (4) Whether the component is installed during construction of the structure.

The regulations contain an example applying the Factors Test to interior office partitions for tenants. If they must be demolished and destroyed when they are removed, then they are real property. Alternatively, if they are readily removed, remain in substantially the same condition as before, and can be reused, then they are not real property.

The following example was added to the regulations to show the interaction of the State Law Test, the Listed Assets Test and the Factors Test:

J owns water pipeline in State X that it wants to exchange for cell phone towers located in State Y. On the date that J transfers the water pipeline in an exchange for the cell phone towers, the water pipeline is classified as real property under the law of State X, the jurisdiction in which the water pipeline is located. The water pipeline is real property, regardless of whether the water pipeline is a Listed Asset or is real property under the Factors Test. Cell phone towers are a Listed Asset as an inherently permanent structure. Thus, the cell phone towers that J acquires in the exchange for the water pipeline are real property, regardless of the State or local characterization of the cell phone towers or whether the cell phone towers are real property under the Factors Test.

**Types of Exchangeable Interests.** The taxpayer must have an exchangeable interest in the real property asset, which the regulations refer to as an “intangible interest”. These intangible interests include the usual forms of real property ownership such as fee ownership, co-ownership, a leasehold, and an easement, as well as shares in a mutual ditch, reservoir, or irrigation company described in section 501(c)(12)(A) of the Code (if, at the time of the exchange, such shares have been recognized by the highest court of the State in which the company was organized, or by a State statute, as constituting or representing real property or an interest in real property). The regulations also provide that stock in a cooperative housing corporation, and land development rights are interests in the real property for Section 1031 purposes. In addition, the regulations provide that an option to acquire real property is an interest in real property. They further provide that other similar types of interests are real property under Section 1031 if the intangible asset derives its value from real property or an interest in real property and is inseparable from that real property or interest in real property.

The regulations state that those intangibles that were specifically excluded in former Section 1031(a)(2) before the 2017 amendment are still not eligible regardless of state or local law classification. The excluded intangibles are stock, bonds, notes, other securities or evidences of indebtedness or interest, interests in a partnership (other than an interest in a partnership that has in effect a valid election under section 761(a) to be excluded from the application of all of subchapter K), certificates of trust or beneficial interests, and choses in action.

A license, permit, or other similar right that is solely for the use, enjoyment, or occupation of land (e.g. land use permit) or an inherently permanent structure and that is in the nature of a leasehold, easement, or other similar right, generally is an interest in real property. The regulations provide the following example:

K receives a special use permit from the government to place a cell tower on federal government land that abuts a federal highway. Government regulations provide that the permit is not a lease of the land, but it is a permit to use the land for a cell tower. Under the permit, the government reserves the right to cancel the permit and compensate K if the site is needed for a higher public purpose. The permit is in the nature of a leasehold that allows K to place a cell tower in a specific location on government land. Therefore, the permit is an interest in real property.

In contrast, a license or permit to engage in or operate a business on real property (e.g. a casino license) is not real property or an interest in real property, regardless of its classification under state or local law.

**Like-Kind Standard.** The IRS pointed out that the regulations only apply to determine what is real property for the purposes of Section 1031 and they do not apply to the like-kind standard. Thus, a leasehold of less than 30 years remaining is not like-kind to a fee interest even though they are both real property. Further, machinery assets may not be like-kind to all other real property. In CCA 201238027, the IRS stated that federal law, and not state law, controls on whether real property is like-kind to other real property. In that CCA, the IRS held that a steam turbine was not like-kind to land because it did not have the same nature and character as land, even though the steam turbine was real property under state law. In the preamble to the final regulations, the IRS discussed the steam turbine example in the CCA, but did not reverse the like-kind holding. Thus, a steam turbine affixed to land is like-kind real property to another steam turbine affixed to land, but the IRS may contend that it is not like-kind to land with no steam turbine. Given the broad definition of real property in the final regulations, future Section 1031 rulings may focus on the like-kind standard and not the real property classification.

**Depreciation Classification.** An asset can be real property for Section 1031 purposes but personal property for depreciation purposes. The regulations specifically state that they have no application to depreciation classification or depreciation recapture rules. Thus, a steam turbine might be depreciated as personal property and subject to depreciation recapture in an exchange, regardless of the Section 1031 classification as real property.

**Using QI Funds for Personal Property.** Under the (g)(6) limitations of the QI safe harbor, a QI may not use exchange funds to pay for anything other than the replacement property while the exchange is still in progress. There is an exception for “(g)(7) items”, allowing the QI to use the exchange funds to pay “*transactional items that relate to the disposition of the relinquished property or 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)*”. The regulations add “*personal property that is incidental to replacement real property*” as an item that can be paid by the QI as a (g)(7) item without blowing the QI safe harbor. Under the regulations, personal property is incidental to real property acquired in an exchange if, in standard commercial transactions, the personal

property is typically transferred together with the real property, and the aggregate fair market value of the incidental personal property transferred with the real property does not exceed 15 percent of the aggregate fair market value of the replacement real property. The regulations make it clear that incidental personal property is still not real property and thus is taxable boot in the exchange if it is paid for with exchange proceeds.

**Summary.** The regulations give a taxpayer several methods to classify an asset as real property for Section 1031 purposes, and therefore eligible for gain deferral. It seems like only those items that would typically be considered personal property, such freestanding furniture and equipment, will be considered personal property for Section 1031 purposes. The regulations do not address like-kind issues or depreciation treatment, and questions will remain in those areas. The addition of incidental personal property to the (g)(7) items is certainly helpful to QIs and taxpayers to avoid constructive receipt worries, and the 15% limitation will cover most personal property allocations in a real property acquisition.