

December 04, 2020

New Rules Further Limit Section 1031 Like-Kind Exchanges

Related Practices

Real Estate
Tax

On November 23, 2020, the Treasury Department and Internal Revenue Service (IRS) issued final Treasury Regulations (T.D. 9935) governing like-kind exchanges under Section 1031 of the Internal Revenue Code of 1986, as amended (the Code), which clarify the definition of real property eligible for like-kind exchanges and also address the receipt of personal property received in a like-kind exchange. For those unfamiliar with the concept, the Code permits taxpayers to sell an appreciated asset (referred to in a Section 1031 transaction as the relinquished property) and defer capital gains that would otherwise be due by immediately using proceeds from the sale for investment into replacement property that is of a “like-kind” to the relinquished property.

In 2017, Congress enacted the Tax Cuts and Jobs Act of 2017 (Pub. L. No. 115-97) (the TCJA), which amended Section 1031 of the Code to reduce the types of property eligible for like-kind exchanges. Specifically, the TCJA limited like-kind exchange treatment to the sale of real property held for use in a trade or business or for investment, thereby eliminating nonrecognition treatment for most types of personal or intangible property (such as machinery, equipment, vehicles, artwork, collectibles, patents, and other intellectual property).

The new rules provide that real property eligible for like-kind exchange treatment is property that is (i) classified as real property under applicable state or local law; (ii) specifically listed as real property in the final regulations; or (iii) considered real property based on a facts and circumstances test described in the final regulations. Further, the final regulations provide that tangible personal property incidental to the exchange of real property may be included in a like-kind exchange so long as, in part, the aggregate value of such property does not exceed 15 percent of the total value of replacement property acquired in the exchange.

Neither the final regulations nor its preamble discuss which state or local law governs with respect to the classification of real property. Specifically, it remains unclear what controls to the extent of any conflict between state and local laws, such as, for example, conflict between a state's sales tax laws and other state or local laws. Notwithstanding the state and local law rule under the final regulations, property ineligible for like-kind exchange treatment following enactment of the TCJA (such as certain tangible personal property) remains ineligible regardless of its classification under the applicable laws of a state or local jurisdiction.

Under the final regulations, "real property" means land and improvements to land, unsevered natural products of land, water and air space superjacent to land, and certain intangible assets associated with real property. An "improvement to land" includes an "inherently permanent structure", which is any building or other distinct asset described in the final regulations that is permanently affixed to real property and will ordinarily remain affixed for an indefinite period. A few examples of an inherently permanent structure listed in the final regulations include in-ground swimming pools; roads; bridges; parking facilities; stationary wharves and docks; fences; telephone poles; cell, broadcasting and electric transmission towers; oil and gas pipelines; and oil and gas storage tanks. An improvement to land also includes an inherently permanent structure's "structural components," which are distinct assets described in the final regulations that are a constituent part of, and integrated into, an inherently permanent structure, and which may include interconnected assets working together to serve such structure. Examples of structural components include walls; doors; plumbing systems; HVAC systems; elevators and escalators; fire suppression systems; and security systems, among others. To the extent a particular item may qualify as an inherently permanent structure or a structural component thereof, but it is not explicitly listed in the final regulations as a distinct asset, the final regulations set forth certain facts and circumstances tests to use for making this determination.

Intangible property that is real property for purposes of Section 1031 includes fee ownership; co-ownership; a leasehold; an option to acquire real property; an easement; stock in a cooperative housing cooperation; land development rights; and certain licenses and permits for the use, enjoyment, or occupation of land, among others. Similar interests may also qualify where the intangible asset derives its value from real property or an interest therein and the asset is inseparable therefrom.

Other property that does not qualify as "real property" under Section 1031 of the Code may be included in a Section 1031 exchange provided it is incidental to real property acquired in an exchange, it is included in standard commercial transactions together with the real property, and the aggregate fair market value of the incidental property does not exceed 15 percent of the aggregate fair market value of the replacement property.

Although the final regulations will reduce uncertainty in like-kind exchanges, taxpayers should seek legal counsel to ensure compliance with all applicable rules and to structure the exchange in a way that can maximize tax deferral. If you are planning on selling commercial or investment properties, contact your real estate and tax attorneys at Michael Best to assist you with evaluating Section 1031 opportunities and completing your like-kind exchanges. If you are contemplating selling any property qualifying as real property under the new regulations prior to the end of 2020, you may consider conducting a Section 1031 exchange before January 1 to mitigate the risk of potential changes in law regarding Section 1031 exchanges.

Related People



Jonathan Luljak

Associate

jtuljak@michaelbest.com

T 414.225.4962