Proposed Regs Define "Real Property" for Section 1031: IRS Gets It Mostly Right but Insists on Perpetuating Earlier Mistake

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In general, the proposed regulations provide reasonable guidance to taxpayers on the question of what is "real property" and thus eligible for like-kind exchange treatment; however, they err in jettisoning any reference to state law as a touchstone in making this determination.

From 1921 until 2018, Section 1031 permitted like-kind exchanges of both tangible and intangible real and personal property, with certain types of property excluded. The Tax Cuts and Jobs Act of 2017 ("TCJA") changed that, limiting application of the deferral regime of Section 1031 to real property for exchanges commencing January 1, 2018.[1] In making this change, Congress did not eliminate the "like-kind" standard applicable when comparing relinquished to replacement property, it simply limited both to being some form of real property. In addition, in the House Conference Report to accompany TJCA, Congress expressly directed that real property previously eligible for like-kind exchange treatment should continue to be eligible, indicating lack of intent to change the parameters applicable to determination of what constitutes like-kind real property.[2]

While the question of what constitutes real property and what real property is like-kind has been present since the adoption of Section 1031, the current Treasury Regulations are silent on what is "real property," instead focusing on the issue of what real property interests are like-kind to each other. Under the Regulations, what matters for this test is a comparison of exchanged properties'

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"nature or character" not "grade or quality."[3] Whether real property is improved or unimproved is not material, nor is the character of the property as productive or unproductive, except where held by a dealer. The additional gloss provided by the current Regulations compares and treats as like-kind exchanges (1) city real property for a ranch or farm and (2) a leasehold interest of 30 or more years for a fee interest in real property.[4]

As will be discussed below, the issue of what constituted like-kind real property gave rise to frequent questions and engendered both a significant number of judicial decisions and IRS rulings. In light of the TCJA's contraction of Section 1031, IRS decided it was appropriate to provide more "certainty regarding whether any part of the replacement property received in an exchange is non-like-kind property." On June 11, 2020, IRS released Prop. Reg. 1.1031(a)-3, which carries a June 12, 2020 Federal Register publication date, referred to here as the "Proposal." Along with the Proposal, IRS released an ancillary clarifying rule relating to personal property transferred or received in an otherwise qualifying like-kind exchange of real property.[5]

We applaud the Treasury and IRS for undertaking an effort to clarify the area. In general, we believe the Proposal provides reasonable guidance to taxpayers on the question of what is "real property" and thus eligible for like-kind exchange treatment. However, we believe that the Proposal errs in jettisoning any reference to state law as a touchstone in making this determination. This position, staked out in a 2012 IRS Chief Counsel Advise memorandum[6] that mirrors the investment tax credit rules, inappropriately limits the definition of real property in a manner inconsistent with prior law and with Congressional intent.

Prior Authority Defining Real Property

Before reviewing what the Proposal does, it is useful to undertake a survey of what the law has said is real property for Section 1031 purposes until now, particularly since Congress instructed taxing authorities and taxpayers that the rules would not change.

Courts have historically looked to state law for the definition of "real property" when undertaking a like-kind analysis under Section 1031. Originally, once some courts determined exchanged property qualified as real property under state law, such courts concluded such properties were like-kind without further analysis. However, some courts have shifted from treating state law real property classifications as determinative to informative. These courts then undertake further analysis considering other relevant facts and circumstances.

One early case, *Crichton,*[7] treated state law classification of real property as determinative of whether such properties were like-kind. In *Crichton,* an undivided interest in an improved city lot was exchanged for an undivided interest in oil, gas, and other mineral rights; these were found to be like-kind properties where mineral rights qualified as real property under state law. The Fifth Circuit relied exclusively on the fact that the mineral rights were real property under Louisiana law, noting that "[t]he commissioner concedes, as he must, that under Louisiana law, mineral rights are interests not in personal but in real property, and that the rights exchanged were real rights."[8]

In *Oregon Lumber Co.*,[9] the Tax Court rejected a taxpayer's attempt to equate a timber cutting right to a fee interest in real property. The court found that the cutting rights were personal property under Oregon law and held that "[a]n exchange of realty for personalty is not an exchange of property for property of like-kind."

In *Fleming*,[10] the Tax Court held that the transfer of fee simple title to a ranch in exchange for limited overriding royalties and oil payment rights did not qualify as a like-kind exchange. The limited overriding royalties and oil payment rights entitled the taxpayer to receive production from certain oil and gas leases up to a fixed amount plus interest. Once this amount had been received, the interests would revert to the owner of the leases. The court indicated that in determining whether the properties were of like-kind, it was required to consider not only "the nature and character of the physical properties, but also the nature and character of the title conveyed or the rights of the parties therein." The court distinguished *Crichton* on the ground that the mineral interest conveyed in that case was not for a limited period. The court found that the oil payment rights in *Fleming* created rights wholly different from the fee simple interest in land for which they were exchanged, stating that "a temporary title to the oil properties, continuing only until a sum of money is realized therefrom, is not equivalent to an absolute and unconditional title in the ranch land."

Similar to the decision in *Fleming*, the Tax Court ruled in *Clemente Inc.*[11] that an exchange of land rights to extract a limited amount of gravel from other land did not qualify as like-kind. A similar conclusion was again reached in *P.G. Lake, Inc.*[12] In this case, the Supreme Court held that a transfer of "oil payments" that were expected to pay out in 3–4 years in exchange for interests in realty was not like-kind. The transferred "oil payments" represented future income from oil leases, and, as such, they were a different kind or class of "property" from the realty received.

In *Koch*,[13] the Tax Court held that an exchange of a fee interest in real property for a fee interest in real property subject to 99-year condominium leases qualified as a like-kind exchange and that the right

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1 Section 13303 of P.L. 115-97 (131 Stat. 2054).

2 *See* H. Rep't No. 115-466 at 396, fn. 726 (2017) (Conf. Rep.).

3 Reg. 1.1031(a)-1(b).

4 Reg. 1.1031(a)-1(c)(2).

5 Prop. Reg. 1.1031(k)-1(g)(8)(vi).

6 CCA 2012238027.

7 122 F.2d 181 (CA-5, 1941).

8 *Id*. at 182.

9 20 TC 192 (1953).

10 24 TC 818 (1955).

11 TCM 1985-367.

12 356 U.S. 260 (1958).

13 71 TC 54 (1978).

14 126 TC 261 (2006).

15 For further discussion of this law, *see* Weller & Alton, "Does State Law Really Determine Whether Property is Real Estate for Section 1031 Purposes?" 32 J. Real Estate Tax'n 1 (Fourth quarter 2004).

to receive rent under the condominium leases was not boot for purposes of Section 1031 because the economic situation of taxpayer was fundamentally the same as it was before the transaction occurred and the nature and character of the transferred rights in respective properties were substantially alike. The court explained that the main distinction between *Crichton* and *Fleming* was the duration of the interests involved (i.e., the "duration-of-the-interests" test).

In *Peabody Natural Resources Co.*,[14] the issue was whether coal supply contracts that burdened coal mine property received by a partnership, as part of an exchange under Section 1031, was like-kind property to the gold mining property transferred by the partnership. The two coal supply contracts were for 17 and 14 years, respectively, but had renewal options that could extend such contracts beyond 30 years. The first part of the analysis in *Peabody* focused on whether the supply contracts were treated as real property under New Mexico law. The court explained that the supply contracts were classified as contracts for the sale of goods under the New Mexico Uniform Commercial Code, but that this classification did not preclude the contracts from also effectuating a transfer of an interest in real property under New Mexico law. In the second part of its analysis, the Tax Court considered whether the supply contracts were like-kind to the gold mining property Peabody had transferred. The Tax Court concluded that gold mining property was like-kind under Section 1031 to coal supply contracts (as well as coal mining property).[15]

The IRS has also based analysis of real property classification for Section 1031 purposes on state law in a number of instances. The Service's prior ruling history also contains a wide variety of qualifying like-kind exchanges where the Service has seemingly relied partially or completely on state law classifications of real property. Examples of such rulings include:

- A scenic conservation easement, found to be real property under state law, for a fee simple interest in timberland, farmland, or ranch land. *See* Ltr. Rul. 9621012.
- An agricultural conservation easement in perpetuity in a farm, found to be real property under state law, for a fee simple interest in real property. *See* Ltr. Rul. 9232030. *See also* Ltr. Rul. 200201007 and companion Ltr. Ruls. 200203033 and 200203042.
- A perpetual conservation easement encumbering real property for a fee simple interest in either (i) farmland, (ii) ranch land, or (iii) commercial real property. *See* Ltr. Rul. 9601046 (the conservation easement in question was granted by the taxpayer to the federal government over real property the taxpayer had held for many years for productive use in the business of cattle grazing and duck hunting).

The Tax Cuts and Jobs Act of 2017 limits application of the deferral regime of Section 1031 to real property for exchanges commencing January 1, 2018.

In 2012, the IRS deviated from its prior views (as well as those expressed by courts) and asserted a position that effectively presaged the current Proposal. In Chief Counsel Advice (CCA) 201238027, IRS asserted that federal tax law rather than state law controls when determining whether property is like-kind for purposes of a Section 1031 exchange. In reaching this conclusion, the CCA analyzes a set of four hypothetical Section 1031 exchange cases:

- Case 1: A natural gas pipeline classified as personal property in State A is exchanged for a natural gas pipeline classified as real property in State B.
- Case 2: A steam turbine (attached as a fixture to a building and used in the commercial production of electricity for this case and all following cases) is classified as real property in State A and is exchanged for a similar steam turbine located in State B but is classified as personal property in that state.
- Case 3: A steam turbine treated as real property in State A is exchanged for raw land in State B.
- Case 4: A steam turbine and a natural gas pipeline, both treated as real property in State A, are exchanged for a State B natural gas pipeline that is treated as personal property in State B.

In analyzing these cases, the CCA recognized that earlier precedent had stated that state law is determinative when classifying property as either real or personal, but dismissed this precedent, asserting that "the courts relied on more than just the state law classification in their analysis of whether the exchanged properties are of like-kind." By noting that courts relied on "more than just" state law classification, the CCA principally acknowledged that the courts did in fact rely on such classification, at least in part. However, since state laws differ in how they characterize real and personal property, the CCA argues that relying strictly on state law property classifications would result in federal tax law being dependent on state laws and state policies. In support of this view, the CCA noted that the court in *Oregon Lumber*, in addition to considering state law classifications, considered whether the properties at issue were fundamentally similar. The CCA also focused on the court's statement in *Peabody* that "consideration should be given to… any…factor bearing on the nature or character of the properties as distinguished from the grade and quality." Finally, the CCA observed that the Supreme Court in *Morgan* stated, "federal law must prevail no matter what name is given the interest or right by state law." Finally, and in a clear preview of the approach taken in the current Proposal, the CCA referred to Sections 48, 263A, and 1245, and stated that these sections are informative when making the determination of what is real property for purposes of federal law.

In its analysis of the four hypothetical cases, the CCA first found the pipelines in Case 1 to be like-kind for purposes of Section 1031, even though both were not classified as real property for purposes of state law. The CCA stated that regardless of how property is classified for state or federal tax law, it does not change or override the basic nature and character of the property involved. Instead, the CCA describes natural gas pipelines as inherently permanent structures that are of the same nature and character as land, improvements, or other real property, and they should always be treated as real property for purposes of Section 1031.

In Case 2, the CCA found the steam turbines in both State A and State B to be of the same nature and character, so they, regardless of their classification under state law, are like-kind. However, because these steam turbines are used as machinery in the commercial production of electricity and are not structural components, the CCA found that they should not be treated as real property in other situations when applying Section 1031.

In Case 3, the CCA found that a steam turbine is not of the same nature and character as raw land and, thus, not like-kind. Although in State A the steam turbine was real property, the CCA again concluded that it should not be treated as real property for Section 1031 purposes.

Finally, in Case 4, the CCA found that a steam turbine and a natural gas pipeline are not of like-kind. Relying on its prior analysis for Case 1 and Case 2, the CCA concluded that the natural gas pipeline should be treated as real property and the steam turbine should again be treated as personal property for Section 1031 purposes.

The CCA made no attempt to recognize that, where courts had deviated from state law definitions of real property in evaluating Section 1031 exchanges, it was never on the threshold issue of what was real property, but on the separate issue of whether two interests in real property were like-kind to each other, typically where one interest was complete permanent ownership (i.e. a fee interest) and the other interest involved less than complete permanent ownership.

In reaching its conclusion that identical properties must be like-kind regardless of state law classification as real or personal, the CCA noted that case law supported the overlay of federal principles to state law classification and noted that where properties have the same nature or character, state law classifications should not override their like-kind classification.

The CCA offered no basis under prior law for the Case 3 denial of like-kind treatment between complete permanent ownership of a steam turbine classified as real property under applicable state law and complete permanent ownership of land except to assert that the turbine, albeit a fixture regarded as real property, did not have the same nature or character as land. IRS has applied a similar analysis in later guidance. For example, in Ltr. Rul. 201706009, the IRS noted that "state law classifications of property are not the sole determiner of whether two sets of property are of like-kind for [Section] 1031 purposes," and that "state law property classification are not the sole basis" for determining whether property is like-kind. However, in stating that state law characterization is not the "sole determiner" or "sole basis" for determining like-kind status, IRS tacitly acknowledged that state law characterization has some ongoing relevance as a "determiner" for purposes of Section 1031 by virtue of prior court holdings, even if such characterization is not dispositive on the issue.

The Proposal and Its Rationale

It is with this background and context that the Proposal was developed. Carrying forward the position expressed in CCA 201238027, in its introduction to the Proposal, IRS observes that a number of other regulations provide definitions of real property, including capitalization issues addressed in Regs. 1.263(a)-3(b) and 1.263A-8(c), cost recovery "recapture" addressed in Reg. 1.1250-1(e)(3), REIT qualification addressed in Reg. 1.856-10 and foreign ownership classification addressed in Reg. 1.897-1(b). We shall refer to these in general as the "related regulations." Noting that there are similarities and differences in the definitions that "reflect the different purposes underlying those provisions," the introduction states, "[t]he Treasury Department and the IRS have concluded that it would not be appropriate to adopt wholesale as the definition of real property for purposes of Section 1031 an existing definition of real property from another section of the Code or regulations." Significantly, and in our view quite correctly, in explaining why the definition applicable to REITs in Reg. 1.856-10 (providing property having an active function such as producing, manufacturing, or creating a product is not real property) shouldn't apply to Section 1031, IRS says "nothing in pre-TCJA Section 1031 law suggests that real property held for productive use in a trade or business or for investment should necessarily be excluded from the definition of real property because of an active rather than passive function."

Notwithstanding this, with some tweaks to accommodate two specific issues, the Proposed Regulations adopt

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16 Prop. Reg. 1.1031(a)-3(a)(1).

17 For discussion of this issue, *see* Foster, "Exchanges of Real Estate Contract Rights," Journal of Passthrough Entities, Nov-Dec 2012, p 13.

18 Prop. Reg. 1.1031(a)-3(a)(2)(ii)(B) refers to advertising displays treated as real property for Section 1033(g)(3) purposes, outdoor lighting facilities, railroad tracks and signals, telephone poles, power generation and transmission facilities, telecommunication cables, microwave, 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.

19 (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. Prop. Reg. 1.1031(a)-3(a)(2)(C).

20 Prop. Reg. 1.1031(a)-3(b)(3).

21 Prop. Reg. 1.1031(a)-3(a)(2)(D).

the same approach to the definition of like-kind real property as found in the CCA, based on principles derived from the expansive classification of personal property for purposes of qualifying for investment tax credits under Section 48, as reflected in Regs. 1.263(a)-3(b) and 1.263A-8(c), as well as the restrictions of the REIT regime to traditional real property rather than manufacturing businesses, as reflected in Reg. 1.856-10, and taxation of foreign real property investment under Sections 897, 1445 and 6039(c), all governed by the real property definition found in Reg. 1.897-1(b). The Proposal makes no mention of the significant body of published authority (discussed earlier in this article) that has previously addressed this definition, nor does it describe specific similarities and differences between existing authority under Section 1031 and the much more recent IRS definitional rules adopted for the other regimes.

This results in the overall definition of real property to include land and improvements. Improvements include buildings and "other inherently permanent structures" or "OIPS" for purposes of this article. The Proposal expressly says that, with one limited exception, "local law definitions are not controlling for the purpose of determining the meaning of the term real property."[16]

Interests in real property can vary from outright fee ownership. In listing several types of ownership interests that qualify as real property, the Proposal specifically includes options to acquire real property, which by their nature do not involve present possessory interests (unless coupled with a lease or license). Under current law, it was not clear whether gain recognized on the sale of real property option or contract rights could qualify for deferral under Section 1031 when the seller never took title to the underlying property.[17] Thus, this aspect of the Proposal will be viewed as beneficial to taxpayers. However, the Proposal says nothing about what "like-kind" test will be applied to options, most significantly, whether an option to purchase a fee interest in real estate would be deemed like-kind only to another option or to a fee interest itself. If the former is true, the inclusion of options as real property will have limited value. If the latter is true, a whole new set of planning opportunities opens up for exchanges of "in the money" options or contract rights.

The OIPS term comes directly out of the regulations mentioned above. Of course, the investment tax credit regime was designed to apply only to personal property, so exclusion of real property was clearly necessary and appropriate, but the regulations under Section 48 (Reg. 1.48-1(c)) made a policy decision to include machinery, regardless of whether classified as real property for local law purposes, as being personal property. That definition expanded the categories of property eligible for the investment tax credit in order to encourage its acquisition and use—the purpose of the investment tax credit regime. The examples in this regulation include a gasoline pump or an automatic vending machine "annexed to the ground."

In the Proposal, the term "building" is broadly defined, and quite intuitively, to include "any structure or edifice enclosing a space within its walls and covered by a roof," going on to provide "[b]uildings include the following distinct assets if permanently affixed: houses, apartments, hotels, motels, enclosed stadiums and arenas, enclosed shopping malls, factories and office buildings, warehouses, barns, enclosed garages, enclosed transportation stations and terminals, and stores." However, the definition goes further and suggests there is a functional aspect that must be considered by adding that "the purpose of which is, for example, to provide shelter or housing, or to provide working office, parking display or sales space." This introduction of a functional component to the definition of real property is where the Proposal starts to go astray.

Since improvements can include more than buildings, the OIPS definition goes on to describe numerous kinds of man-made additions to land that are included in the definition of real property as "inherently permanent" or "permanently installed." Specifically, the Proposal lists: "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."[18] Something may be regarded as permanently affixed by reason of weight alone and, where a specific type of OIPS is not listed in the Proposal, it provides a five-factor test to establish qualification.[19] The test is essentially a surrogate for the common law definition of a fixture. It has the salutary effect in Example 3 of the Proposal of making a large indoor sculpture placed in the atrium of a building a real property asset[20] but this example raises the question of whether the same sculpture would be real property if placed on a specially poured foundation outside the same building.

Courts have historically looked to state law for the definition of "real property" when undertaking a like-kind analysis under Section 1031.

The Proposal next categorically excludes "machinery" from the definition of real property by saying as a definitional matter that machinery or equipment "is generally not an inherently permanent structure and not real property for purposes of this section."[21] A carve-out of this blanket rule involves machinery included as a structural component of a building or OIPS that serves the structure and "does not produce or contribute to the production of income other than for the use or occupancy of space."[22] Again we see a functional test which also appears in the REIT regulations treating as real property assets eligible for REIT ownership OIPS that serve a "passive function" and "do not serve an active function"[23] where no prior law defining real property under Section 1031 had involved this.

The Proposal's regime flows from but makes no mention of the concept of "fixtures" associated with real property common law for centuries. It appears that the IRS has intentionally omitted any reference to the term "fixtures," aside from a single reference in Example 8, which is patterned from the steam turbine cases in the CCA. The concept of fixtures is embedded in state law definitions of real property and has essential consequences in defining which laws govern contracts, remedies, secured transactions, ad valorem taxation, sales and use taxes, statutes of repose and limitation (and probably other issues). For 500 years, the legal principle has been that personal property becomes real property when attached to land and intended to be permanently associated with land.[24] Nevertheless, the concept that fixtures are real property is incorporated into all the definitions contained in the related regulations.

Unfortunately, the classification of fixtures is not uniform among the states. Essentially, the same assets can be classified as fixtures, and thus real property, in some states and not others. This has created a conundrum for taxpayers and IRS for many years – as illustrated by Cases 1 and 2 of the CCA. But the solution proposed by the CCA – that identical assets must qualify as like-kind, regardless of state law real vs. personal property classification, because they must be considered to have the same nature or character – is no longer available where assets must be real property to be eligible for Section 1031 treatment. The solution is to adopt, in effect, a federal rule simply defining oil and gas pipelines as OIPS and thus real property. This is highlighted in Example 10 contained in the Proposal;[25] the consequences of this approach are discussed later in this article.

One type of property that received beneficial treatment, consistent with prior law, is classification of unsevered natural products of land such as growing crops, plants, timber, water, ores, and minerals as real property that cease to have that classification once severed, extracted, or removed from the land.[26]

The Proposal sets up three categories of property that can be viewed as real property but must be analyzed separately: (a) land, (b) inherently permanent structures, and (c) structural components of an inherently permanent structure.[27] In defining structural components, the Proposal focuses (in the same way as the related regulations) on whether an item is a constituent part of, and integrated into, an inherently permanent structure. A laundry list of examples is provided, as well as a four-part test applicable where an alleged structural component is not on the list.[28] This four-part test provides that the following factors are relevant: "(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."

Rather than conceding that a building is a building for analytic purposes, the Proposal introduces the concept that structural components of a building are separate and distinct assets for analytic purposes, subject to inquiry associated with another four-factor test: "(A) Whether the item is customarily sold or acquired as a single unit rather than as a component part of a larger asset; (B) Whether the item can be separated from a larger asset, and if so, the cost of separating the item from the larger asset; (C) Whether the item is commonly viewed as serving a useful function independent of a larger asset of which it is a part; and (D) Whether separating the item from a larger asset of which it is a part impairs the functionality of the larger asset."[29]

The Proposal is clearly fond of multifactor definitional tests. It remains to be seen how often this test will be applied and when it will matter. However, two of the examples in the Proposal suggest there is mischief afoot. In Example 5, an electric generator installed to provide backup power to a building, including a permanently installed 12-ton 3D-printer that produces airplane wings (obviously not for paper airplanes) is a structural component and, therefore, real property. But in Example 6, the same generator was installed to provide backup power solely to the 3D-printer, a machine that the Proposal says is not real property, thereby precluding the same generator from being real property based only on how its potential power (remember it is a backup unit) is used within the building.

The Proposal also tackles a topic that has been somewhat controversial over the years and may continue to give rise

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22 *Id.*

23 Reg. 1.856-10(d)(2)(iii)(A).

24 *See* Kratovil, Fixtures and the Real Estate Mortgage, 97 U. Pa. L. Rev. 180, 181 (1948), citing *Wistow's Case of Gray's Inn*, 14 Hen. VIII, f. 25b (1522) (holding that a millstone was properly characterized as real property even if temporarily removed from the mill for repairs), available online at https://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=8756&context=penn_law_review (last visited July 23, 2020).

25 Prop. Reg. 1.1031(a)-3(b)(10).

26 Prop. Reg. 1.1031(a)-3(b)(10).

27 Prop. Reg. 1.1031(a)-3(a)(3). *See Peabody Natural Resources*, *supra*.

28 Prop. Reg. 1.1031(a)-3(a)(2)(iii)(B) provides that "[s]tructural components include the following items, 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."

29 Prop. Reg. 1.1031(a)-3(a)(4)(ii).

30 Prop. Reg. 1.1031(a)-3(a)(5)(i).

31 *Id.*

32 Prop. Reg. 1.1031(a)-3(a)(5)(ii).

33 Prop. Reg. 1.1031(a)-3(b)(11).

34 Prop. Reg. 1.1031(a)-3(b)(12).

35 Prop. Reg. 1.1031(a)-3(b)(5)(ii).

36 Prop. Reg. 1.1031(a)-3(b)(5)(iii).

37 Prop. Reg. 1.1031(a)-3(b)(6).

38 REG-117589-18 (06/12/2020), Explanation I.B. pg. 12.

to disputes. This relates to intangible assets associated with real property. Before describing this more generally, we note that the Proposal faithfully follows the direction of Congress not to take away real property classification from mutual ditch, reservoir, or irrigation company stock for entities described in Section 501(c)(12)(A) where "the 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."[30] However, there is no indication in the legislative history that Congress intended to disregard state law characterization of real property outside of specific categories of intangibles. Rather, in the Conference Report, Congress uses these three categories merely as an "example" for the proposition that real property eligible like-kind treatment under current law will continue to be eligible. The Proposal incorrectly treats this Conference Report example as an exhaustive list of the real property that will be eligible by virtue of state law characterization.

More generally, an intangible that (a) derives its value from a real property interest, (b) is inseparable from that interest, and (c) does not produce or contribute to the production of income other than for use or occupancy of space is real property.[31] This includes licenses, permits, or similar rights "in the nature of a leasehold or easement" but not licenses or permits to engage in a business on real property if they contribute to production of income other than as consideration for use and occupancy of the real property.[32]

These rules seem reasonable and should generally be easy to apply. A permit to use public land for placement of a cell tower is like a lease, even if applicable law provides that such permits are not leases but grant right of use and are terminable by the government if the site is needed for "a higher public use."[33] But license to operate a casino in a specific building that cannot be transferred to another building is not real property.[34] Assuming the license is transferable to a buyer of the building, it presumably has significant value, likely exceeding its adjusted cost basis. In the past, where the building was sold with the license, gain associated with the license could have been deferred if the seller acquired another licensed casino building. Post-TCJA, under these facts there will be no ability to defer gain on value allocated to the casino license on a sale – encouraging sellers to artificially depress the value of the license rights. Of course, this may be countered by saying that buyers will still want to assign value to such licenses in order to amortize their costs under Section 197 over 15 years rather than be subject to 39-year cost recovery under Section 168.

The Service's prior ruling history also contains a wide variety of qualifying like-kind exchanges where the Service has seemingly relied partially or completely on state law classifications of real property.

The Extended Machinery Exclusion and its Consequences

The most controversial aspect of the Proposal is almost certain to be its decision to adopt the position taken by the CCA that excludes assets classified as machinery from Section 1031 eligibility even where such assets are clearly real property under state law and would have almost certainly qualified as such for Section 1031 purposes under prior law. Reg. 1.1031(a)-3(a)(2)(ii)(D) makes this exclusion explicit, in the same manner as the same carveout in Regs. 1.263A-8(c)(4), 1.856-10(d)(2)(i) and 1.897-1(b)(3)(iii)(B). In fact, the preamble to the Proposal explicitly references these sections when explaining the Machinery Exclusion. Thus, even a 12-ton machine installed during a building's construction and designed to remain in place indefinitely is not real property.[35] A backup generator installed at the same time that serves both the printer and the building is real property,[36] but if the generator serves only the printer, it isn't.[37] The same is true of a gas line incorporated within a building that serves only to provide fuel to business equipment in the building producing goods or services for consumption outside the building, "such as fryers and ovens in a building utilized as a restaurant."[38]

A steam turbine "attached as a fixture to the building" and installed during construction of the building (of course the subject of the CCA) that is owned by an electric utility company meets the same fate. Because it generates electricity for distribution into the electric grid for sale to customers in the ordinary course of the utility's business, it is not OPIS real property solely because it produces income other than for use in the building.

The Proposal can make no reference to prior law involving classification of real property for Section 1031 purposes by reference solely to its uses because there is none. None of the judicial analyses adopting a federal overlay to state law classification involved such an approach. It is found in the regulations arising from quite different regimes where what is done with property drives availability of tax subsidy treatment: the investment credit regime's objective to provide tax benefits for investment in productive asset classes and the REIT regime's objective to limit the single level of taxation afforded by allowing a dividends paid deduction to certain entities taxed as corporations that is available only where they do not engage in active conduct of what is viewed as non-real property activities.

The consequences of the Proposal's approach, if retained in final regulations, will be to restrict 1031 treatment of property where operating assets would otherwise qualify as fixtures and thus real property on a generally uniform basis. We think this may apply most often to power generation situations, as the scale of generating equipment - steam turbines, gas turbines, wind turbines, solar arrays and the like – all involve assets that will meet the definition of OIPS but for the machinery exclusion. But the printer example and the reference to gas lines in a restaurant suggest the exclusion can be far broader and apply to a wide variety of industries that rely upon productive equipment large enough to also meet the OIPS test, and thus almost certain to have been real property under pre-Proposal law.

In addition to power generation (not just generators, but potentially alternative energy installations like windmills and solar arrays), product production via 3D-printing technology and restaurants, it appears to us that virtually any sort of special utility or HVAC installations in a building designed for industrial or commercial use can also be declassified as real property under the Proposal. Consider the following, in each case involving assets that would currently be regarded as real property since they are permanently installed and would be normally regarded as fixtures under state real property law:

- A cold storage facility with built-in refrigeration equipment and associated piping and electrical equipment embedded in the structure but serving solely the refrigeration equipment.
- Specialized HVAC equipment used to cool a specific portion of a building where data processing equipment requiring constant temperature control is housed.
- A fuel center that is installed to independently produce power for commercial/residential buildings where excess capacity generated is sold back to the power company.

If these types of assets are not real property for Section 1031 purposes, then regardless of whether a taxpayer wishes to undertake a cost segregation study (discussed below) the Proposal may force taxpayers to undertake extensive cost analysis of the amount of newly determined personal property in virtually all commercial buildings that house specialized machinery or are designed to produce goods or services delivered offsite.

In the end, we think that affected industries are likely to weigh in on the issue.

Incidental Property Clarification

The Proposal addresses and solves an issue that has concerned some advisors since restriction of Section 1031 to real property went into effect in 2018. Since proceeds from sale of personal property can no longer qualify for like-kind exchange deferral, concern arose where proceeds from sale of real property were placed with a qualified intermediary in a typical deferred exchange structure under Reg. 1.1031(k)-1(g) and then used to purchase replacement real property that also included personal property elements—think of an office building acquired along with its lobby furniture and service equipment. First, the regulations provide that where the personal property associated with replacement real property doesn't exceed 15% of the total value of the combined real and personal property, no separate identification of the personal property is necessary. However, this rule only applies to the identification process, and does not make the personal property portion of replacement property like-kind to relinquished real property. It continues to be important to distinguish between what is allowed under this identification safe harbor and the need to separately account and report exchange treatment of real property and non-exchange treatment for personal property.

Second, the constructive receipt elements of the deferred exchange regulations gave rise to an issue where relinquished property proceeds held by a qualified intermediary were used to purchase replacement property comprised of both real and personal property. Here, the concern was that such a transaction violated the requirement that proceeds held by a qualified intermediary only be used to purchase qualifying real property or to pay for customary costs associated with such an acquisition, such as title and escrow charges. If a taxpayer used QI funds to purchase personal property, did that result in deemed constructive receipt of all funds held by the QI or just in boot treatment for the value of the personal property since it was not like-kind to the relinquished real property?

The Proposal addresses this in a favorable way by saying the same 15% test applicable to identification will also apply to use of relinquished property proceeds to buy replacement property consisting of both real and personal property. This is accomplished by adding an incidental personal property exception to those items to which funds held by a qualified intermediary can be applied. As proposed, this consists of personal property incidental to real property that does not exceed 15 percent of the aggregate value of the replacement real property.[39] This applies only where the personal property is typically transferred along with the real property in standard commercial transactions. An example illustrating the provision is also added that illustrates both the continued boot treatment of personal property receipt and the constructive receipt safe harbor: where relinquished property worth $1,100,000 having basis of $400,000 is transferred (resulting in $700,000 realized gain) and replacement real property worth $1,000,000 plus $100,000 in associated personal property is identified and acquired, the taxpayer recognizes $100,000 of the total realized gain due to the non-like-kind personal property receipt but is not deemed to be in constructive receipt of the $1,100,000 placed with the QI and thus defers $600,000 of the realized gain.

The Proposal asks for comments about whether the 15% level is an appropriate one for this purpose. While it seems generally reasonable, if the Machinery Exclusion remains in place, this level may not be sufficient.

Mixing the Message for the Cost Segregation Industry

Contained in the Proposal as Reg. 1.1031(a)-3(a)(6) is a useful provision that states "[t]he rules provided in this section concerning the definition of real property apply only for purposes of Section 1031." This section goes on to make clear that classification of property as real property for Section 1031 does not preclude the property from qualifying for rapid cost recovery

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[39] Prop. Reg. 1.1031(k)-1(g)(7)(iii).

under Section 168 in a manner that gives rise to the potential for recapture under Section 1245 rather than Section 1250. Of course, this sort of classification is at the heart of a common approach to gaining accelerated deductions via cost segregation of assets associated with real property that can be classified as eligible for 5-, 7-, or 15-year recovery and, potentially, the bonus depreciation rules of Section 168(k). The issue of whether property classified as personal property for Section 1245 purposes can be real property for Section 1031 has been frequently asked by taxpayers in order to determine what rule applied to replacement real property when relinquished real property that had been segregated was exchanged, or where a taxpayer wished to undertake a cost segregation study on replacement real property when the relinquished property in an exchange had not been subject to such a study and had thus been entirely land and Section 1250 property. Answering this directly is valuable.

The Proposal also properly provides a reminder that the recapture rules of Section 1245 will apply if relinquished Section 1245 real property is not replaced with equivalent replacement Section 1245 real property

However, we believe there is bad news for the cost segregation industry because identification of building elements that only serve machinery, as defined in the Proposal, will exclude these elements from Section 1031 deferral if they are part of relinquished property and may create boot in an otherwise apparently valid exchange if they are part of replacement property. Consider exchanging bare land worth $100X for land and a building housing a restaurant, also worth $100X. To make things simple, assume all moveable kitchen and dining room furniture, fixtures, and equipment is owned by a tenant. Certain electrical and gas lines are permanently attached to or embedded in the building but are intended to serve only the kitchen equipment and were recently upgraded at a cost of $5X. These have a value of $1X in the mind of the taxpayer but $5X in the mind of the seller. Does this mean the taxpayer acquiring the land and building has boot of $1X in its exchange? Does this mean that there is $5X boot? Will taxpayers be forced to hire their own "personal property" valuation appraisers for every like-kind exchange of industrial or commercial property?

The Proposal tackles a topic that has been somewhat controversial over the years and may continue to give rise to disputes relating to intangible assets associated with real property.

None of these alternatives are particularly appealing but seem the inevitable consequence of the Machinery Exclusion contained in the Proposal.

Unfinished Business

There are several pieces of unfinished business that the Proposal either omits to discuss or on which it invites comments.

In no particular order of importance or suggestion of completeness, the following is a list of items that we believe should be considered for additional or clarifying regulatory guidance:

- Outdated components of Reg. 1.1031 dealing with personal property transactions could be eliminated.
- The consequences of allocation of debt to personal property in multiple asset exchanges pursuant to Reg. 1.1031(j)-1 that now seems to compel boot treatment where mixed real and personal property subject to debt is transferred because the debt automatically allocated to the personal property cannot be offset by acquisition of like-kind personal property.
- While not consequences of the TJCA modification to Section 1031, the following topics invite corrective or further guidance: (i) Numerical errors in the examples in Reg. 1.1031(k)-1(a) should be corrected; (ii) Regulations under Section 1031(f) should be issued, particularly to clarify the scope of Section 1031(f)(2)(C) and make clear that prior approval of the Secretary is not necessary for application of the "non-tax avoidance" exception incorporated in this provision and to define parameters associated with the anti-abuse principle codified in Section 1031(f)(3); (iii) Regulations clarifying boot offset treatment in multi-party and deferred exchanges, particularly whether and when there is new cash paid by a taxpayer or new debt financing obtained by the taxpayer to acquire replacement property cash or debt relief received by the taxpayer on disposition of relinquished property.

Conclusion

The issuance of specific guidance defining real property for Section 1031 purposes is welcome and IRS and Treasury clearly spent a great deal of time and thought in crafting the Proposal. In general, we think the Proposal will provide a useful guide but needs to be walked back from its adoption of the novel position unilaterally taken in CCA 201238027 that real property for state law is not real property for Section 1031, in light of the decades of case law to the contrary and the wholly different rationales for classification of property types that drove the distinctions found in the related regulations.