IRS Proposes New Like-Kind Exchange Regulations

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The 2017 Tax Cut and Jobs Act (TCJA) limited like-kind exchanges occurring after 2017 to "real property held for productive use in a trade or business or investment if such real property is exchanged for real property of a like kind …" Taxpayers can no longer defer gain on the exchange of personal property or certain intangible property held for productive use in a trade or business or for investment under Section 1031 of the Internal Revenue Code of 1986 (Code). The mechanics for a like-kind exchange generally were not changed by the Tax Act.

Proposed Regulations

The Internal Revenue Service (IRS) recently issued **proposed regulations** that would limit the application of the like-kind exchange rules to exchanges of real property and adapt an existing incidental property exception to apply to a taxpayer's receipt of personal property that is incidental to real property the taxpayer receives in the exchange. That is, because personal property and certain intangible property no longer qualify for like-kind exchange treatment, guidance provided by the proposed regulations is needed to define the term "real property," and determine when personal property and intangible property being exchanged will be treated as part of the real property and subject to like-kind exchange treatment, rather than non-like-kind property subject to the gain recognition rules of Code Section 1031(b).

The proposed regulations take a broad (and taxpayer-favorable) approach to defining "real property" in order to implement Congressional intent in amending Code Section 1031. Instead of wholesale adoption of an existing real property definition used in another Code or regulation section, the proposed regulations incorporate certain aspects from existing regulatory definitions of real property to ensure that real property eligible for like-kind exchange treatment under pre-TCJA law continues to be eligible for like-kind exchange treatment after the enactment of the TCJA.

The preamble to the proposed regulations states the following:

> *Under the proposed regulations, real property includes land and improvements to land, unsevered crops and other natural products of land, and water and air space superjacent to land. Improvements to land include inherently permanent structures and the structural components of inherently permanent structures. The proposed regulations also provide that local law definitions generally are not controlling in determining the meaning of the term "real property" for purposes of section 1031.*

In addition to defining "real property," the proposed regulations define a number of other terms utilized in the determination of what constitutes real property, including "improvements to land," "inherently permanent structures," "building," "distinct assets" that are inherently permanent structures, "machinery," "structural components," "unsevered natural products of land," "intangible assets," and "licenses and permits." In the case of structural components and distinct assets, the proposed regulations provide a list of these items and, if an item is not listed, factors to consider in determining whether an item is a structural component or a distinct asset. The proposed regulations also contain 12 examples of items that are or are not treated as real property.

The existing regulations contain rules addressing exchanges involving an intermediary who facilitates a like-kind exchange. A taxpayer wishing to exchange real property (the relinquished property) it owns for like-kind real property (the replacement property) held by another taxpayer may not be able to convince the owner of the replacement property to accept the relinquished property in a like-kind exchange. The owner of the replacement property might want cash for its property. In this case, an intermediary can be used to acquire the replacement property and exchange it for the relinquished property in a like-kind exchange. Specific rules apply (1) to the terms of the agreement between the owner of the relinquished property and the intermediary, and (2) to how the funds used for the exchange (the exchange funds) can be used.

The preamble to the proposed regulations notes that there has been concern that if exchange funds are utilized to purchase any assets in a real estate transaction that are classified as personal property, then, because exchange funds are used to purchase property not eligible for like-kind exchange treatment, there will be a deemed receipt of funds by the owner of the relinquished property and the transaction will not be eligible for gain deferral. The proposed regulations provide that if personal property is acquired with exchange funds, such personal property is regarded as "incidental" if (1) in standard commercial transactions, the personal property is typically transferred together with real property; and (2) the aggregate fair market value of the incidental property does not exceed 15% of the aggregate fair market value of the replacement property. This **does not make the personal property received like-kind**, however, and the taxpayer may have to recognize partial gain.

The preamble also discusses the rationale for arriving at the 15% figure. Specifically, the IRS believes that a figure in excess of 15% "might induce taxpayers to bundle more personal property with their exchanged property [which] would lead to increased amounts of personal property exchanged with real property under section 1031 and effectively unlock a class of personal property that would no longer be 'incidental' to the real property," but that a lower limit would be economically burdensome to taxpayers measuring the separate costs of comingled personal and real property. In further support of its 15% figure, the IRS believes that "most taxpayers will be indifferent when exchanging incidental property, plants, and equipment with a depreciable life of 20 years or less that is eligible for 100 percent additional first year depreciation, commonly referred to as 'bonus depreciation'." However, as discussed below, **bonus depreciation is not permanent**.

The proposed regulations request comments regarding the treatment of a taxpayer's receipt of personal property that is incidental to the taxpayer's replacement real property in an intended like-kind exchange. In addition, comments are requested regarding the two-factor analysis for determining whether personal property is incidental to real property acquired in such an exchange. In particular, comments are requested with regard to the appropriateness of the proposed 15% fair market value limit set forth in that test for personal property transferred with real property.

Public comments, which may be written or electronic, on the proposed regulations and requests for a public hearing must be **received by August 11, 2020**.

Personal Property Exchanges

Like-kind exchange treatment is mandatory if its requirements are met. For example, if a taxpayer traded in a truck used in its business for a new truck before 2018, the trade-in would be treated as a like-kind exchange. The taxpayer could not treat the trade-in as a sale of the old truck and the purchase of a new truck. To illustrate, assume a taxpayer in 2017 traded in a truck with a fair market value of $10,000 and a tax basis of $1,000 for a new truck costing $50,000. The taxpayer paid the truck dealer $40,000 in addition to trading in its old truck. (Assume neither truck is subject to special rules that limit yearly depreciation deductions.) The taxpayer would recognize no gain on the transaction. The taxpayer's tax basis in the new truck would be $41,000 (the $1,000 of tax basis in the old truck plus the $40,000 paid for the new truck). The taxpayer would have $41,000 of tax basis to depreciate. In 2017, the taxpayer would have been entitled to 50% bonus depreciation, giving the taxpayer an immediate deduction of $20,500.

If the same transaction occurred in 2018 when personal property no longer qualifies for like-kind exchanges, the tax treatment would be different. The taxpayer would have $9,000 of gain on the sale of the old truck (excess of $10,000 deemed sale price over $1,000 tax basis) and a tax basis of $50,000 in the new truck. The old truck would qualify as property described in Code Section 1231. The gain would be taxed as ordinary income. Generally, gains on Code Section 1231 property are treated as capital gains and losses are treated as ordinary losses. To the extent that the taxpayer claimed depreciation on the truck, however, gain would be treated as ordinary income (so-called "recapture" of depreciation claimed). If the taxpayer were eligible for bonus depreciation on the truck, it would have a $50,000 deduction. The ordinary income of $9,000 on the sale would be offset by the bonus depreciation, leaving a $41,000 deduction. If 100% bonus depreciation were available in 2017, the taxpayer's net tax position would have been the same. It would have had no net gain on the trade-in and a $41,000 bonus depreciation deduction.

The 100% bonus depreciation, however, is not permanent. It is **scheduled to end in 2022**. Thus, while the TCJA limiting of like-kind exchanges to real property does not increase the 2018 tax liability over the like-kind exchange treatment for trading in the truck in 2017, the tax result will change when 100% bonus depreciation is eliminated. Moreover, not all personal property formally eligible for like-kind exchange treatment is eligible for 100% bonus depreciation. For example, franchise agreements, distribution rights, licenses (liquor, FCC, etc.), and collectibles are not eligible for 100% bonus depreciation. Additionally, special rules limit yearly depreciation for certain vehicles.

It should be noted that the change made by the Tax Act to Code Section 1031 does not alter the more general rules in the regulations regarding when an exchange results in gain or loss. Not all exchanges of personal property after 2017 will be taxable. Code Section 1001(a) provides that the gain from the sale or other disposition of property is the excess of the amount realized therefrom over the adjusted basis. Section 1.1001-1(a) of the Income Tax Regulations provides that the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property *differing materially either in kind or in extent*, is treated as income or loss sustained. In other words, **the exchange of property must give the taxpayer "a thing really different from what he theretofore had."** *Weiss v. Stearn*, 265 U.S. 242, 254 (1924). Whether two items exchanged differing materially either in kind or in extent is an issue that has been litigated, including at the U.S. Supreme Court. Thus, even though an exchange of personal property generally will result in gain or loss, taxpayers should consider whether the two items differ materially either in kind or in extent before treating the exchange as taxable.

Please reach out to one of the authors or any member of McGlinchey's Tax team for help or questions.

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