

# Winners and Losers in Like-Kind Exchange Final Regulations

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The Treasury Department and the IRS received 21 written comments in response to the [like-kind exchange proposed regulations](#) (see our [earlier alert](#)). The recently issued [final IRS like-kind exchange regulations](#) adopt some comments (Winners), reject some comments (Losers), and do not consider some comments because they are beyond the scope of the regulation project (Punts).

Regulations are needed because the 2017 Tax Cut and Jobs Act (TCJA, also called the Tax Act) limited like-kind exchanges occurring after 2017 to “real property held for productive use in a trade or business or investment.” IRC § 1031 does not define the term “real property.” The main purpose of the regulations has been to define the term “real property,” especially with regard to the **exchange of personal property (including fixtures) and intangible property** that are often part of a real property transaction. The regulations attempt to provide some clarity as to what 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 IRC § 1031(b). As expected, this has both succeeded in part and failed in part.

The changes from the proposed regulations to the final regulations are generally taxpayer favorable, making it easier to determine personal property and intangible property that will qualify for like-kind exchange treatment.

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## WINNERS

### 1. State Law Definition of Real Property Generally Controls

The proposed regulations provide that state or local law definitions are not controlling for purposes of determining whether property is real property for IRC § 1031 purposes. Several comments recommended that the final regulations expand the rules to rely significantly, or wholly, on state-law classifications for all assets. In response to these comments, the final regulations provide generally that property is real property for purposes of IRC § 1031 if, on the date it is transferred in an exchange, that property is classified as real property under the law of the state or local jurisdiction in which that property is located (state and local law test). The state and

local law test applies to both tangible and intangible property classifications.

Prior law will continue to apply, however, in that real property eligible for like-kind exchange treatment under the law in effect before the TCJA will continue to be eligible for like-kind exchange treatment after enactment of the TCJA, but property ineligible for like-kind exchange treatment before the TCJA remains ineligible, including real property that was excluded from the application of IRC § 1031. Thus, under the final regulations, **property is classified as real property for purposes of IRC § 1031 if the property is (i) so classified under the state and local law test**, subject to certain exceptions, (ii) specifically listed as real property in the final regulations, or (iii) considered real property based on all the facts and circumstances under the various factors provided in the final regulations. A determination that property is personal property under state or local law does not preclude the conclusion that property is real property as specifically listed in the final regulations or as real property under the factors listed in the final regulations.

## 2. Nature or Character Reasoning in CCA 20128027 Is Not Adopted

In [Chief Counsel Advice 201238027](#) (April 17, 2012), the IRS disregarded state law that characterized a steam turbine as real property and held that the steam turbine was not of like kind to land because it did not have the same nature or character as land. Comments objected to this conclusion, contending that the state law classification of the steam turbine as real property should be respected and, based on that classification, the steam turbine and the undeveloped land should be considered like-kind property.

Because the final regulations expressly include the state and local law test, they do not adopt the reasoning of CCA 201238027 to the extent it suggests that state or local law is disregarded in determining whether property is real property under IRC § 1031. The final regulations **do not address whether exchanged properties are of like kind** to one another. Presumably, a steam turbine now could qualify as real property under the final regulations.

## 3. Elimination of Proposed Purpose or Use Test

Under the proposed regulations, real property includes land and improvements to land, and improvements to land include both inherently permanent structures and the structural components of inherently permanent structures (buildings or other structures that are permanently affixed to real property and that will ordinarily remain affixed for an indefinite period of time). The proposed regulations also consider the function of property in determining whether the property is real property for IRC § 1031 purposes (purpose or use test). Neither tangible property, such as machinery or equipment, nor intangible property, such as licenses or permits, is classified as real property under the proposed regulations if the property contributes to the production of income unrelated to the use or occupancy of space, irrespective of any other factor under the proposed regulations. For example, a gas line installed for the sole purpose of providing fuel to fryers and ovens in a restaurant is not a constituent part of an inherently permanent structure, and, therefore, not real property under the proposed regulations.

Comments uniformly disagreed with the purpose or use test and advocated that it be omitted from the final regulations. In response to these comments, the final regulations **eliminate a purpose or use test for tangible property and intangible property**. Consequently, tangible property is treated as real property for IRC § 1031

purposes, if (i) such property is permanently affixed to real property and (ii) it ordinarily will remain affixed for an indefinite period of time, irrespective of the purpose or use of the property or whether it contributes to the production of income. A structural component likewise is characterized as real property under the final regulations if it is integrated into an inherently permanent structure, regardless of whether the structural component contributes to the production of income. Thus, **items of machinery and equipment are characterized as real property if they comprise an inherently permanent structure**, a structural component, or are real property under the state or local law test.

No comments were received regarding the application of the proposed purpose or use test to real property classifications of intangible property. Nevertheless, under the final regulations, whether intangible property produces or contributes to the production of income other than consideration for the use or occupancy of space is not considered in determining whether intangible property is real property for IRC § 1031 purposes, but the purpose of the intangible property remains relevant to the real property determination.

#### 4. Clarification of Term “Permanently Affixed”

One comment noted that the proposed regulations do not define the phrases “permanently affixed” or “indefinite period of time” for purposes of defining “inherently permanent structure” (other than providing that affixation to real property may be accomplished by weight alone), and that these terms should be clarified by adopting language in §1.856-10(d)(2)(i) of the Income Tax Regulations. In response to this comment, the final regulations provide that “[a]ffixation is considered permanent if it is reasonably expected to last indefinitely based on all the facts and circumstances.”

#### 5. Offshore Platforms and Pipelines

The proposed regulations specifically list offshore *drilling* platforms (but not production offshore platforms) and oil and gas pipelines as inherently permanent structures, and therefore such property is defined as real property. Also, underground pipelines, isolation valves and vents, and pressure control and relief valves are real property, but meters and compressors are not real property. One comment suggested deleting *drilling* from *offshore drilling platforms* to clarify that offshore production platforms qualify as real property, clarifying that above-ground pipelines qualify as real property, and treating meters and compressors as real property. In response to this comment, the final regulations delete *drilling* to make clear **offshore production platforms qualify as real property** and clarify that above-ground pipelines qualify as real property.

With respect to meters and compressors, the final regulations provide that the unique facts and circumstances of the particular meters or compressors must be considered to determine whether they are real property. If the unique circumstances affecting individual pipelines require substantial amounts of time and money to prepare, construct, and place in service, the components would be real property.

#### 6. Stock in a Cooperative Housing Corporation, Development Rights, and Licenses and Permits

Comments requested that stock in a cooperative house corporation and development rights for land be listed as interests in real property, and that licenses and permits not be limited to those that are in the nature of a leasehold or easement. In response to these comments, the final regulations list **stock in a cooperative housing**

**corporation and development rights for land as interests** in real property. With respect to licenses and permits, the final regulations are revised to provide that **a license, permit, or other similar right** that is solely for the use, enjoyment, or occupation of land or an inherently permanent structure and that is in the nature of a leasehold, an easement, *or a similar right* **generally is an interest in real property** and thus is real property under section 1031.

## 7. Applicability of Distinct Asset Test to Three-Property Rule

The proposed regulations provide that, in general, each distinct asset is analyzed separately from each other distinct asset in determining whether a distinct asset is real property for IRC § 1031 purposes. One comment requested that the final regulations clarify that this distinct asset rule does not apply for purposes of the three-property rule, which generally limits a taxpayer to the identification of three replacement properties. In response to the comment, language is added to the final regulations to clarify that the **distinct asset rule applies only for purposes of determining whether property is real property** and does not affect the application of the three-property rule.

## 8. Do Not Apply 15% Incidental Property Limitation on a Property-By-Property Basis

One comment recommended that the final regulations clarify that **the 15% limitation for the incidental property rule not be applied on a property-by-property basis**. (See item 3 under Loses for an explanation of the incidental property rule). For example, assume a taxpayer acquires an office building (Building 1) with office furniture, and a second office building (Building 2) with no personal property. The comment requested that the final regulations confirm that the taxpayer does not exceed the 15% limitation if the value of the furniture is 15% or less of the total value of all the replacement property (Building 1 and Building 2), even if the value of the furniture exceeds 15 percent of the value of just Building 1. The final regulations adopt this recommendation.

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## LOSERS

### 1. Acceptance of Other States Definition of Real Property

One comment recommended that any asset determined to be essentially the same as an asset classified as a real property for purposes of IRC § 1031 also should automatically be treated as real property for purposes of IRC § 1031. For example, if one asset (Property A) is classified as real property under the state or local law of State X, an asset located in a different jurisdiction (Property B) that is essentially the same as Property A also should be classified as real property for IRC § 1031 purposes, irrespective of whether Property B is classified as real property under (i) the law of the state or local jurisdiction in which Property B is located or (ii) the real property definition and factors under the proposed regulations. The final regulations do not adopt the change proposed by this comment.

## 2. Requests to List Additional Tangible Personal Property as Real Property

Several comments requested that certain specific tangible personal property be listed as real property, including the following:

- installed appliances (*e.g.*, refrigerators, stoves, dishwashers, and microwave ovens);
- sheds and carports;
- WiFi systems; and
- trade fixtures.

The final regulations **do not specifically list any of these suggested assets as real property**. According to Treasury and the IRS, the final regulations are intended to provide tests under which taxpayers can evaluate the particular facts and circumstances of the property in question to determine with certainty whether particular property is characterized as real or personal property. To limit complexity of the final regulations, the characterization of the above-listed items is most appropriately determined based on the application of the state and local law test or the various factors in the final regulations.

One comment also requested clarification regarding whether carpeting is considered real property or personal property, and another comment inquired whether wires installed within the walls of an office building are real property if the wires were installed specifically for computer workstations that produce income for the business, as distinguished from wiring that is a constituent part of, and integrated into, an inherently permanent structure. These items are not addressed in the final regulations because qualification of such items would be dependent upon a facts-and-circumstances analysis unique to the specific carpeting or wiring, as well as the classification of such items under applicable state or local law.

## 3. Increase the 15% Limitation Under the Incidental Property Rule

The incidental property rule in the proposed regulations provides that, for exchanges involving a qualified intermediary, personal property that is incidental to replacement real property (incidental personal property) is disregarded in determining whether a taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or non-like-kind property held by the qualified intermediary are expressly limited as required by current regulations. Personal property is incidental to real property acquired in an exchange if (i) in standard commercial transactions, the personal property is typically transferred together with the real property, and (ii) the aggregate fair market value of the incidental personal property transferred with the real property does not exceed 15% of the aggregate fair market value of the replacement real property (15% limitation). Although incidental property meeting these requirements does not disqualify an exchange involving a qualified intermediary from like-kind exchange treatment, as personal property, incidental personal property is non-like-kind property that generally results in gain recognition under IRC § 1031(b) on the exchange.

Several comments recommended a change to the calculation of the amount of incidental property that a taxpayer may acquire and still meet the requirements of the incidental property rule. Several comments recommended calculating the 15% limitation on the total fair market value of the replacement real property, as well as the incidental property. Another comment suggested the incidental property rule should permit the aggregate fair market value of the incidental personal property to equal up to 20% of the aggregate fair market value of the replacement real property. The final regulations do not adopt these comments.

#### **4. Identify Incidental Property Rule as a Safe Harbor**

Comments requested that the **incidental property rule be specifically identified in the final regulations as a safe harbor**. The final regulations do not adopt this request. Although the final regulations do include language specifically providing that the receipt of incidental personal property results in taxable gain, as was suggested by one comment, the IRS opined that identifying the incidental rule as a safe harbor would be confusing because it is an item which is disregarded in determining if an existing safe harbor applies, and therefore, operates as part of an existing safe harbor.

#### **5. No Gain Recognition on Incidental Property**

Several comments recommended that the final incidental property rule provide that a taxpayer's receipt of personal property incidental to the real property received in a like-kind exchange be treated as the receipt of real property, and thus not give rise to recognized gain. The final regulations do not adopt this recommendation.

#### **6. Suggested Language Changes to Incidental Property Rule**

One comment recommended deleting the term "commercial transaction" from the incidental property rule because inclusion of the term might be interpreted to include only contracts involving transfers of non-residential property such as commercial real estate and not residential rental property. The final regulations do not adopt this recommendation as it is unnecessary because the term "commercial transaction" refers to **transactions involving business or investment property** rather than personal use property. Similarly, the final regulations do not adopt the recommendation to replace the language "the personal property is typically transferred together with the real property" with "the personal property is typically listed in the contract and transferred with the real property."

#### **7. Apply Incidental Property Rule Retroactively**

A comment requested that the incidental property rule apply retroactively to exchanges occurring before certain dates. The final regulations do not adopt this request.

#### **8. Clarifications Regarding Escrow Funds and Unforeseen Receipt of Personal Property**

Comments requested clarification regarding the application of the incidental property rule to cash placed in escrow to pay transactional and other items in a real estate transfer. The final regulations do not make this clarification. A taxpayer's receipt of escrowed funds that the taxpayer placed in escrow for transactional-type items is not a receipt of incidental personal property.

A comment requested guidance regarding situations in which an exchanging taxpayer acquires a substantial amount of personal property due to unforeseen circumstances. The final regulations do not address this specific situation. The 15% limitation is not a bright-line test for determining whether a transaction fails to meet the requirements of an exchange under IRC § 1031. All of the facts and circumstances of the taxpayer's situation are considered in determining if the exchange meets the requirements.

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## PUNTS

### 1. Duration of Easements and Leaseholds

Several comments requested that the final regulations specify the duration of an easement or leasehold for it to qualify as an interest in real property, although the comments varied in the durations suggested. The final regulations do not address the duration of an easement or leasehold. Treasury and the IRS view the duration of an easement or leasehold as **more relevant to a determination of whether the exchange is of like kind** than to whether the interest is an interest in real property. Because like-kind determinations exceed the scope of the final regulations, the comments' suggestions and requests for clarification regarding like-kind determinations are not adopted.

### 2. Application of Installment Method to Gain on Transfer of Real Property

A comment recommended that the final regulations provide clarification regarding the application of the installment method (IRC § 453) to certain like-kind exchanges and the **timing of gain recognition** in certain situations. The final regulations do not address these issues because they are beyond the scope of the regulation project.

### 3. Application of Current Special Rule for Exchanges of Multiple Properties to post-TCJA exchanges

Existing regulations provide an exception to the general rule that IRC § 1031 requires a **property-by-property comparison for computing the gain recognized** and basis of property received in a like-kind exchange (Section 1.1031(j)-1 of the Income Tax Regulations). Several comments inquired about the application of this exception to exchanges of multiple properties following the enactment of the TCJA. The application of this exception to post-TCJA exchanges is not addressed in the final regulations because the issue is beyond the scope of the regulation project.

### 4. Modification of Revenue Rulings 2003-56 and 2004-86

One comment suggested that [Rev. Rul. 2003-56](#), 2003-23 I.R.B. 985, likely needs to be modified to address post-TCJA exchanges involving both real and personal property, and questioned whether [Rev. Rul. 2004-86](#), 2004-33 I.R.B. 191, needs to be updated to address the TCJA changes to IRC § 1031. Rev. Rul. 2003-56 addresses certain issues **when partnerships engage in like-kind exchanges**, and Rev. Rul. 2004-86 addresses whether a Delaware Statutory Trust in an interest in real property for purposes of IRC § 1031. The final regulations do not address the issues raised by this comment as they are beyond the scope of the regulation project.

### 5. Interaction of Bonus Depreciation Rules with IRC § 1031

One comment discussed the interaction between the additional first year depreciation deduction rules in IRC § 168, commonly referred to as **bonus depreciation**, and the like-kind exchange rules in IRC § 1031, as amended by the TCJA. The final regulations do not address the issues raised by this comment as they are beyond the scope of the regulation project.

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## CONCLUSION

On balance, the final regulations provide helpful changes to the proposed regulations. Nevertheless, TCJA's exclusion of personal property from like-kind exchange treatment has introduced an unwelcomed complexity that is fertile ground for disputes between taxpayers and the IRS for the foreseeable future.

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

### Related people

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