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IRS Clarifies Eligible Like-Kind Property Under Proposed Section 1031 Regulations

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Key Points

- IRS proposed new regulations for like-kind exchanges under section 1031.
- The guidance provides the definition of real property and treatment of incidental personal property in the section 1031 context.

On June 11, 2020, the IRS released proposed regulations for like-kind exchanges under Internal Revenue Code (the "Code") section 1031 to incorporate the Tax Cuts and Jobs Act ("TCJA") changes. Prior to the TCJA, both real property and personal property were eligible for like-kind exchange treatment. The TCJA restricted the tax deferral benefits solely to exchanges of real property. However, the statutory amendment left open the definition of "real property" for section 1031 purposes. The Treasury Department and IRS concluded that taxpayers needed further guidance on what qualifies as real property under section 1031 to determine whether any part of the replacement property would be non-like-kind property subject to gain recognition, as well as the effect of incidental personal property received.

Definition of Real Property for Section 1031

Various Treasury regulations define real property to apply Code sections other than section 1031. Although similar in many ways, the definitions differ in scope to reflect the purposes underlying those particular provisions. To uphold the Congressional intent that real property eligible for like-kind exchange treatment prior to the TCJA continues to be eligible, the Treasury and the IRS rejected fully adopting any existing definition from another section of the Code or regulations. However, the language does resemble the regulations defining real property under section 48, section 263(a), and section 263A.

The proposed regulations define real property as land and improvements to land, natural products of land such as unsevered crops, and water and air space. Improvements include buildings and other inherently permanent structures, as well as their structural components. The regulations also cover intangible property in the nature of a leasehold, easement, or fee ownership as interests in real property for purposes of section 1031.

Each distinct asset must be analyzed separately from any other assets to determine if it is real property under the proposed regulations. If not specifically listed as a permanent structure or structural component, a factor analysis applies to identify the assets.

Incidental Personal Property in a Like-Kind Exchange

The proposed regulations also explain the consequences of the receipt of personal property incidental to the taxpayer's replacement real property in a transaction intended to be a like-kind exchange. According to the Treasury and IRS, taxpayers were concerned whether they could be considered in constructive receipt of all the exchange funds held by a qualified intermediary if the taxpayer could direct those funds to acquire non-like-kind property as part of the transaction, such as personal property within an office building. In response, the regulations clarify that the personal property would not taint the overall exchange so long as it is incidental personal property with a fair market value that does not exceed 15% of fair market value of the related real property.

A taxpayer must still recognize gain on the incidental personal property in accordance with Code section 1031(b). As a result, the proposed treatment does not offer a further tax benefit on the receipt of personal property. In the case where the value of personal property to be transferred exceeds 15% of the real property's value, taxpayers may be required to bifurcate the transaction to qualify for section 1031 tax deferral on the real property. Therefore, parties may need to undertake additional structuring to transfer personal property over the 15% threshold set by the proposed regulations.

For further information on tax planning for eligible like-kind exchanges under section 1031, please contact the Hanson Bridgett Tax Group.

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