A DEEPER DIVE INTO THE UNINTENDED CONSEQUENCES OF THE PROPOSED SECTION 1031 REGULATIONS

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In 2017, the Tax Cuts and Jobs Act (TCJA) amended Internal Revenue Code (IRC) Section 1031 to limit nonrecognition treatment to exchanges of real property for 1031 Exchanges completed after December 31, 2017. The current Section 1031 Regulations do not provide a definition as to what constitutes real property, but instead provides guidance as to what property is “like-kind.” On June 12, 2020, the IRS issued Proposed Regulations 1.1031(a)-3 (REG-117589-18) for Section 1031 to include a definition of real property in response to the TCJA’s statutory changes that limited 1031 exchanges to real property. For many taxpayers, these Proposed Regulations will be a welcome addition as they help to provide clarity for defining “real property” in 1031 exchanges. However, if these Proposed Regulations are finalized as they currently stand, they may cause many unintended consequences for taxpayers.

When the TCJA was passed, Congress specifically noted in Footnote 726 of the Committee Report that, “it is intended that real property eligible for like-kind exchange treatment under present law will continue to be eligible for like-kind exchange treatment under the provision.” These changes in the current Proposed Regulations are inconsistent with Congressional intent, and if unaltered, could place a significant compliance burden and result in an increase in taxable income for taxpayers involved in 1031 exchanges.

The Proposed Regulations require that the function of a distinct asset that is not machinery be considered in determining whether the asset is real property for the purposes of Section 1031. The Proposed Regulations provide that property that is machinery or equipment is not an inherently permanent structure and therefore, is not real property under Section 1031 with one exception. If an inherently permanent structure such as a building includes machinery as a structural component, the Proposed Regulations clarify that the machinery may be considered real property. The machinery must serve the permanent structure and it cannot produce or contribute to the production of income other than for the use or occupancy of space. For assets that are interconnected and work together to serve an inherently permanent structure, the assets should be analyzed together as one distinct asset component.

GAS LINE EXAMPLE

The Proposed Regulations provide an example of a gas line in which real property is separated from personal property based on its use, instead of its physical nature or character. The example indicates that a gas line installed for servicing the building is treated as real property, whereas a gas line installed to service a restaurant within the building is treated as personal property since it contributes to the production of income. The Proposed Regulations 1.1031(a)-3(a)(2)(iii)(A) and (B) define a structural component as being a “constituent part of, and integrated into, an inherently permanent structure.” Based on this definition, and contrary to the conclusion reached in the Proposed Regulations, both gas lines should be considered real property regardless of whether they are used to heat the restaurant oven or the building furnace. Both gas lines contain the same physical characteristics and are permanently affixed to the structure. In CCA 201238027, the IRS previously determined that a pipeline that was characterized differently amongst two states was determined to be real property regardless of state law characterization because it had the same physical characteristics.

The conclusion reached in the gas line example provided in the Proposed Regulations seems to contradict what the Proposed Regulations define as a structural component, as well as the determination made previously by the Chief Counsel Advice (CCA). Prior to the Proposed Regulations, the gas line servicing the restaurant oven would have been considered real property based on legislative history. The Proposed Regulations now define the gas line for the oven as personal property and not eligible for like-kind exchange. If the underlying building is acquired in a 1031 exchange, the gas line servicing the oven would be considered incidental personal property and taxable as boot to the taxpayer. If a taxpayer sold a property in a 1031 exchange that included the gas line for the oven, then the gas line would need to be carved out and disposed of separately from the exchange as a sale of personal property. The taxpayer would recognize gain resulting from depreciation recapture on the gas line.

100% BONUS DEPRECIATION

The Proposed Regulations point out that 100% bonus depreciation can be claimed on any incidental personal property acquired with replacement property in an exchange, in order to alleviate the tax burden placed on taxpayers resulting from the depreciation recapture on the disposal of the relinquished personal property. While claiming bonus depreciation on personal property carved out from the replacement property is beneficial, the Proposed Regulations fail to specify that many states do not conform to the federal bonus depreciation provisions. Hence, taxpayers in those states will have to report depreciation recapture on their state tax returns and will not be able to take bonus depreciation on the incidental personal property received in the exchange to offset the state tax burden. Furthermore, the 100% bonus depreciation provision will expire after 2022, increasing the tax burden for taxpayers and rendering the IRS's point obsolete in the long run. For many taxpayers who engage in a 1031 exchange that spans multiple years, a timing difference may exist. The taxpayer would have to recognize depreciation recapture in the first year when the relinquished property is sold, and would not be able to claim bonus depreciation on the incidental personal property until it is received and placed in service in the second year. This timing difference would place a significant cash flow burden on taxpayers who would have to pay the tax in year one and wait to claim the benefits of any bonus depreciation on the following year's tax return.

FEDERAL VS. STATE

Another important issue that may be overlooked is the increased complexity that would be added if the Proposed Regulations are finalized. The IRS has historically included state law as one of the factors considered in determining whether a property is real property for the purposes of Section 1031. The Proposed Regulations ignore decades of precedent in favor of eliminating state case law as a factor in addressing the nature of property in a 1031 exchange. If enacted, then 1031 exchanges for federal and state purposes would look completely different. The amount of real property in federal 1031

exchanges would likely be lower than the amount of real property reported on state tax returns, resulting in a substantial increase in the complexities of reporting these exchanges on a taxpayer's tax return.

NEW PROVISION TO THE PROPOSED REGULATIONS

The Proposed Regulations include a new provision addressing the treatment of a taxpayer's receipt of personal property that is incidental to the taxpayer's replacement real property received in a 1031 exchange.

The provision requires that personal property must be:

1. Incidental to the real replacement property,
2. That it has an aggregate fair market value of no more than 15% of the fair market value of the real estate, and
3. That it must be typically transferred with the real property in standard commercial transactions.

This new rule, if not satisfied, can potentially disqualify certain 1031 exchanges if the incidental personal property received with the replacement property exceeds 15% of the entire property's fair market value. If the IRS' intent is to provide certainty as to what happens when true personal property is included in an exchange, then the language in the Proposed Regulations should be modified to clarify that any incidental non-like-kind property received in an exchange is treated as taxable boot rather than implementing a rule to disqualify the exchange if it isn't met. Another alternative would be for the IRS to clarify that the 15% threshold is a safe harbor, so that acquisition of incidental personal property valued in excess of 15% of the real property will not disqualify the exchange and cause the sale of the relinquished property to become fully taxable. If the Proposed Regulations are finalized, then the 15% incidental property rule will place a burden on taxpayers, as they will need to have a valuation prepared for every property involved in an exchange in order to confirm that the incidental rule is satisfied and validate the non-taxable nature of the exchange.

If left unchanged, the Proposed Regulations will have an adverse effect on taxpayers by potentially increasing their taxable income when executing 1031 exchanges and placing a burden on them to have to identify these individual building components for both the relinquished and replacement properties in the event of an exchange. It is unreasonable for the IRS to expect taxpayers to be able to quantify these values for 1031 exchange purposes without having to hire a specialist to do it for them. If Congress' objective was to keep 1031 exchanges the same after the enactment of the TCJA, then these Proposed Regulations and the potential increase in taxes, disqualifications, and taxpayer burden that could result are certainly not in line with the original intent. ■

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