Like Kind Exchange Final Regulations & Recent Developments

David L. Silverman, Esq.
2001 Marcus Avenue, Suite N15
Lake Success, NY 11042 (516) 466-5900
nytaxattorney.com
dsilverman@nytaxattorney.com
January 15, 2025

TABLE OF CONTENTS

<u>Appendix</u>

Like Kind Exchange Final Regulations & Recent Developments

David L. Silverman[1], Esq.
2001 Marcus Avenue, Suite N15
Lake Success, NY 11042 (516) 466-5900
nytaxattorney.com
dsilverman@nytaxattorney.com
January 15, 2025

1. **Introduction.** The fortunes of Section 1031 improved in December 2020, with the issuance of final regulations, and again November 2023, with a new administration unlikely to make further changes to the statute. The Tax Cuts and Jobs Act (TCJA), enacted in 2017, narrowed the scope of Section 1031, but left intact its most important category–real property. As amended, Section 1031 now applies only to real property and intangible property deriving value from real property.

2. **Definition of Section 1031.** IRC §1031(a)(1) provides for nonrecognition of gain or loss if real property held for productive use in a trade or business or for investment is exchanged solely for real property

---

1 *David L. Silverman graduated from Columbia Law School and received an LL.M. in Taxation from NYU School of Law. His practice reflects the diverse needs of his clients. It encompasses federal and NYS taxation, estate planning, probate and estate administration, tax litigation, real estate taxation including like kind exchanges and Delaware Statutory Trusts, will contests, estate litigation, special needs trusts, opinion letters, PLRs, Article 78 tax appeals and asset protection. David was a paralegal at Simpson, Thacher & Bartlett before entering law school, and was previously associated with Pryor Cashman, LLP. The experience he gained at these Manhattan firms was invaluable. David is also the writer and publisher of Tax News & Comment, a tax journal. He has written numerous articles on taxation and estate planning. David lectures frequently, and has been licensed by New York to provide CPE credits to New York CPAs for over 20 years.*

of like kind, held either for productive use in a trade or business or for investment. Exchanges must be either simultaneous or structured through a "qualified intermediary" pursuant to the deferred exchange regulations. Section 1031(a)(3) provides relevant time periods for deferred exchanges. Section 1031(b) provides that the receipt of non-qualifying property will not disqualify the exchange, but will result in realized gain being recognized to the extent of such nonqualifying property. Section 1031(d) provides rules for determining the basis in an exchange; and also provides that the assumption of a liability of the taxpayer will be treated as money received.

a. **Evolution of Section 1031.** Since the late 1970's, Section 1031 has continued to evolve through judicial, congressional, and administrative action. The landmark *Starker* case, decided by the Ninth Circuit in 1979, first sanctioned non-simultaneous exchanges. The familiar 45 and 180-day deferred exchange time periods were enacted by Congress in 1984. Deferred exchange regulations followed in 1991. Revenue Procedure 2002-22 sanctioned the use of fractional interests in tenancies in common. Real property status was ascribed to beneficial interests in Delaware Statutory Trusts in Revenue Ruling 2004-86.

b. **Attempts at Repeal.** President Obama sought without success to repeal Section 1031. President Trump signed TCJA on December 22, 2017, which eliminated as qualifying property all personal property. President Biden without success sought to repeal the statute, or to impose monetary limits of $500,000 per individual per year on exchanges. No changes to the statute are envisioned under the second Trump Administration.

3. **Legislative History of TCJA.** The legislative history of TCJA provided that Congress "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 amended statute.[2] Thus, assets qualifying under state law, judicial precedent and IRS rulings before TCJA continue to qualify. However, property *ineligible* for like-kind exchange treatment prior to TCJA remains ineligible.[3] Congressional Republicans reluctantly agreed to the amendment of Section 1031 by the Trump Administration – accepting the premise that "bonus" depreciation served as a proxy for the elimination of personal property.

a. **Partial Rejection of Proposed Regulations.** Between 2017 and 2020, Treasury drafted proposed regulations adhering to the Treasury view that state or local definitions were not controlling in determining whether an asset qualified as real property. This and other provisions were met with considerable disapproval. Many were abandoned or modified in the final regulations. The final regulations were published in December 2020, only six months after the issuance of the proposed regulations. The most important changes were the recognition of State law primacy in characterizing real property, and the introduction of new alternate regulatory system of characterizing real property. Under the new system, qualifying machinery and structural components of "inherently permanent structures" might become elevated to the status of real property.

4. **The Final Regulations.** The final regulations "claw back" personal property banished in 2017 in two ways: **First**, they provide a contextual framework that elevates(i) tangible assets permanently affixed to other real property and (ii) intangible assets deriving value from real property or an interest in real property, to the status of real property, thereby qualifying under 1031; **and second**, by reaffirming the importance of

2 H.R. Conf. Rep't 115-466, at 396, fn 726 (2017).

3 Conf. Rep't at 396, fn 726.

state law[4] in defining real property. Accordingly, an asset is real property under Section 1031 if **(i)** state or local law defines it as such; **(ii)** the asset qualifies under pre-2020 case law or IRS ruling; or **(iii)** the asset qualifies as **(A)** an *"inherently permanent structure" (IPS),* the term "structure" referring to a "building" or other "listed assets," such as houses, hotels, stores, etc.; or **(B)** an *"other inherently permanent structure"*(OIPS), (such as a cell phone tower, a "five ton" sculpture in a building atrium, or other listed asset), or **(C)** a *"structural component" of an "inherently permanent structure"* (such as a heating system, elevator, or other listed asset). The final regulations provide two tests to determine whether non-listed tangible assets qualify as real property: one for inherently permanent structures (IPSs) and "other" inherently permanent structures; and a second test for "structural" components of inherently permanent structures. Thus, an "industrial 3D printer and generator,[5]" as well as other machinery, may now qualify as a structural component of an inherently permanent structure.

---

4 The final regulations evidence the stark departure from earlier Treasury sentiment, which diminished the importance of state law. PLR 200901020 thus opined:

> Not all interests defined as real property interests for state law purposes, are of like kind for purposes of §1031. Although the Service generally looks to state law in determining what property rights constitute real property interests, such classifications are not necessarily determinative of what real property interests are of like kind to other real property interests under federal income tax law. That determination is a matter of federal, not state, law.

5 Example 5 in final regulations, discussed *infra*.

a. **Affirmation of Preeminence of State Law.** The final regulations establish the rule that assets defined as real property under state or local law are real property under Section 1031, with some exceptions.[6] Multiple avenues for real property qualification have therefore opened up: An asset may qualify under pre-TCJA judicial or IRS Ruling, under state or local law, or under the new approach described in the final regulations. This tri-pillared qualification gateway significantly expands the universe of tangible assets – most notably machinery and "structural components" that may now qualify under Section 1031. Intangible assets not already defined as real property under Section 1031 may also now qualify under State law – unless explicitly excluded by the final regulations, as some intangible property is.[7]

b. **Approach Where Two States Classify an Identical Asset Differently.** Should two states classify an asset differently, the paradigm envisioned in the final regulations for testing non-listed assets determines whether the asset qualifies as real property – i.e., as an inherently permanent structure (IPS), an "other" inherently permanent structure (OIPS) or as a structural component of an IPS. No deference is given to either states' law or local law. This marks a notable change from the proposed regulations.

c. **"Inherently Permanent Structures."** The final regulations

---

6 The proposed regulations, released in June, 2020, were criticized. The final regulations, published only six months later, dispensed with objectionable aspects, retained significant portions in modified form, and in some cases reverted to earlier law.

7 H.R. Conf. Rep't 115-466 (2017).

introduce the concept of "inherently permanent structures." At its core, property is an "inherently permanent structure" if it (i) is permanently affixed to real property and (ii) will ordinarily remain affixed indefinitely, regardless of the purpose or use of the property or whether it contributes to the production of income unrelated to the use or occupancy of space.

d. **Partnership Interests & Some Other Intangible Assets Remain Ineligible.** Speculation arose that partnership interests and several other intangible assets expressly excluded under former Section 1031(a)(2)[8] could fortuitously become real property if so defined under state or local law. The final regulations foreclose this hopeful argument by providing "the following intangible assets are not real property for purposes of Section 1031 . . . regardless of state law," and proceeding to list those items.[9]

e. **Elimination of "Purpose or Use" Test.** Under the proposed regulations, tangible property could not be real property if it contributed to the production of income "unrelated to the use or occupancy of space." The final regulations eliminate, with regard to both tangible and intangible properties, any consideration of whether the "particular property contributes to the production of income unrelated to the use or occupancy of space."

8 Section 1031(a)(2) was deleted from the amended statute because it was no longer necessary.

9 Presumably, Congress eliminated explicit reference these exclusions since only real property qualified under the amended statute. The final regulations preclude any attempt construe the omission as creating an opportunity for qualification by explicitly providing that the excluded interests are not real property, regardless of state or local law.

i. **Exception: Purpose Remains Relevant With Some Intangible Real Property.** Although whether an asset contributes to the production of income unrelated to the use or occupancy of space is no longer relevant in most cases involving tangible property, the final regulations emphasize that the purpose of intangible property "remains relevant to the real property determination."

ii. **Non-Transferable License to Operate Business Not Real Property. Example 12** of the final regulations references a license granted to a casino to operate in a building. The license is specific to the building, and cannot be transferred to another location. The example concludes that the license is not for the use, enjoyment, or occupation of the building, but rather to "operate the casino business in the building," and therefore is not real property or an interest in real property. A discussion in the final regulations states:

(1) [T]he Treasury Department and the IRS have determined that many of the comments pertaining to the purpose or use test with regard to tangible property equally apply to classifications of intangible property. As a result, 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 section 1031 purposes. However, the purpose of the intangible property remains relevant to the real property determination.

(2) The apparent contradiction between the elimination of the purpose or use test, yet its "relevance" in intangible real property determinations likely refers to the fact that the purpose or use test refers to the *production of income*. In Example 11, the production of income is not a factor. Rather, the example focuses on the non-transferability of the license. Therefore, while the purpose or use of the property for the production of income is not relevant, the purpose for which the intangible property may be put is still relevant. Example 11 also finds the non-transferability of the license to be an important factor in its conclusion that the license is not real property.

iii. **Final Regulations Example 10. State or Local Law Determination of Property.** J owns water pipeline in State X that it wants to exchange for cell phone towers located in State Y. On the date that J transfers the water pipeline in an exchange for the cell phone towers, the water pipeline is classified as real property under the law of State X, the jurisdiction in which the water pipeline is located. The water pipeline is real property regardless of whether the water pipeline is listed as an inherently permanent structure or a structural component of an inherently permanent structure. Cell phone towers are listed as an inherently permanent structure. Thus, the cell phone towers that J acquires in the exchange for the water pipeline are real property under this section, regardless of the State or local characterization of the cell phone towers.

iv. **Preliminary Note on "Like Kind" Requirement.** While Example 10 establishes that both the cell phone towers and the water pipeline are real property for purposes of Section 1031, it does not discuss whether they are of "like kind."

f. **No Inference Outside of Section 1031.** The definition of real property in the final regulations applies only for purposes of Section 1031. Other Code provisions that reference distinctions between real and personal property are unaffected.[10] Therefore, "no inference" is intended with respect to the classification or characterization of property under Sections 1245[11] and 1250.[12] With respect to Section 1245, the *Gerhardt*[13] case (discussed below) held that if Section 1245 property is disposed of in a Section 1031 exchange, gain from disposition of that property may be recognized as ordinary income. The Tax Court cited Section 1245(a)(1), which provides that gain from the disposition of Section 1245 property "shall be recognized notwithstanding any other provision of this subtitle." Section 1031 will not affect the operation of the following other Code provisions as well: (i) depreciation under IRC §162; (ii) REITs under IRC § 856; and (iii)

---

10 Final Regs. §1.1031(a)-3(a)(7).

11 Section 1245 states that "[g]ain from the disposition of Section 1245 property shall be recognized notwithstanding any other provision of this subtitle." Personal property, such as machinery and equipment, may be subject to depreciation recapture as ordinary income under Section 1245.

12 Unrecaptured Section 1250 gain generally refers to gain realized on the sale or exchange of real estate that has been depreciated on the straight line basis.

13 *Gerhardt v. Com'r*, 160 T.C. No. 9 (4/20/2023).

FIRPTA withholding under §897.[14] Unrecaptured Section 1250 gain rolled over into the replacement property.

5. **Like Kind Determination "Beyond The Scope" of the Regulations.** Determining whether properties are of "like kind" is "beyond the scope" of the final regulations. Therefore, the inquiry continues to involve a review of IRS pronouncements, decisional law, and the regulations. Case law and rulings have viewed exchanges of real property liberally. Whether real properties are of like kind depends

> on the nature or character of the property and not to its grade or quality.[15] One kind or class of property may not be exchanged for property of a different kind or class. [However,] whether any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. Regs. § 1.1031(a)-1(b).

Properties are of the same "nature or character" if they share a similar purpose, function, or use, even if they differ in specific details or quality.

---

14 The Foreign Investment in Real Property Act ("FIRPTA") imposes a tax on "foreign persons" selling U.S. real estate. Foreign persons are (i) nonresident aliens, and (ii) foreign partnerships, corporations, trusts, estates or corporations that have not elected to be taxed as domestic corporations under IRC Section 897(i).If a disposition is subject to FIRPTA the purchaser is required to withhold and remit to the IRS up to 15 percent of the total amount realized from the sale and remit that amount to the IRS unless certain exemptions are met.

15 *Peabody Natural Resources v. Com'r*, 126 T.C. 261 (2006); see also CCA 201238027.

Since many assets that were formerly characterized as personal property now qualify as real property, the contours of the like kind requirement as its applies to these new entrants will likely require IRS or Treasury clarification.

a. **"Like Kind" Determinations Involving Real Property Enjoy Rarefied Status.** Reg. §1.1031(a)-1(c) provides that the exchange of a fee interest for a 30 year lease, or the exchange of city real estate for a ranch or farm, are exchanges of "like kind" property. The exchange of a fee interest for coop shares also qualify as an exchange of "like kind" real property. PLR 943125 stated that a lot held for investment is of like kind with a townhouse to be used as rental property. Although the like kind rules have a permissive tenor, "like kind" matches are often not intuitive, and require caution. For example, Rev. Rul. 67-255 states that a "building" is not of like kind to a "building and land." Section 1031(h) provides that foreign real property is not of like kind to domestic real property. Whether or not real property is "productive" is not relevant since real property held for investment may be exchanged for real property used in a trade or business.

i. **Like "Class" Distinctions No Longer Relevant.** Since personal property no longer qualifies for deferral, "class" differences among items of personal property now have no relevance under Section 1031. All "classes" of personal property are now taxed as gain.[16]

---

16 The final regulations state that "distinguishing between properties of a different class is relevant to personal property and whether, under Section 1031 prior to the enactment of TCJA, personal properties were of like kind, not whether the properties were real property." [26 CFR Part 1; TD 9935; 4839-01-p-36].

b. **Significance of Some Personal Property Now Being Real Property.** The final regulations expand the definition of real property to include assets that were never real property. This makes the "like kind" determination more complex. Given the fact that some IPSs, and seemingly all structural components of IPSs, become real property only if they are affixed (or integrated) into to other inherently permanent structures, once the affixed (or dis-integrated asset in the case of a structural component) the assets revert to personal property. Exchanges of pre-TCJA personal property elevated to real property under the TCJA and the final regulations will not likely be of "like kind" to pre-TCJA real property. It may be the case that a structural component integrated into a larger asset might be of like kind to another larger asset with a structural component.

i. **Example.** Yankee Stadium is not of "like kind" to an "oil and gas pipeline," even though Yankee Stadium qualifies as real property as a non-listed "other" inherently permanent structure"; and the oil and gas pipeline qualifies as real property (if structurally connected and integrated into an inherently permanent structure).

c. **Although Like Kind Rules Permissive, Temporal Issues Arise.** While the final regulations provide that options to acquire real property qualify as property, the regulations are silent with respect to temporal and qualitative aspects; e.g., is an option to acquire real property in one year of "like kind" to a 5-year option, or to a fee interest? Or is a right to divert water that is limited in duration (or scope) of like kind to one that is permanent in duration or unlimited in scope? The final regulations note that the duration of an easement or leasehold – both real property – may be relevant under Regs. §1.1031(a)-1(c) for the purpose of determining whether the "like kind" requirement is satisfied.

6. Incidental Personal Property Received in Exchange.

a. Definition of "Incidental Personal Property" Rule. Following the elimination of personal property under Section1031, concern grew that many exchanges would trigger a "(g)6)" violation since escrow funds would be used purchase not only real property, but also personal property such as furniture and equipment "commingled" with the real property. The final regulations resolve this concern by providing that "incidental" personal property is disregarded in determining whether a taxpayer's rights are expressly limited, as required by Regs. §1.1031(k)-1(g)(6).[17] The rule provides assurance that the use of exchange proceeds to purchase "incidental" personal property will not violate §1031(k)-1(g)(6). Although the rule allays concerns about triggering a "(g)(6)" violation, it only grants an exemption from the deferred exchange escrow rules. It does not transform personal property to real property. Incidental personal property still does not qualify under Section 1031 and will be taxed as gain.

b. Definition of Incidental Personal Property. The incidental personal property rule is defined in Regs §1.1031(k)-1(g)(7)(iii):

> Personal property is incidental to real property acquired in an exchange if, in *standard commercial transactions*, the personal property is typically transferred together with the real property, and the

[17] The incidental property rule is based on an existing rule in the regulations, which provides that certain incidental property is ignored in determining whether a taxpayer has properly identified replacement property.

> aggregate fair market value of the incidental personal property transferred with the real property does not exceed 15 percent of the aggregate fair market value of the replacement real property.[18] (Emphasis added).

c. **Definition of "Commercial Transactions".** The final regulations provide that the term "commercial transactions"refers to

> transactions involving business or investment property rather than personal use property. Accordingly, the term 'commercial' describes the type of transaction, not the type of property. Therefore, a commercial transaction may involve either residential or non-residential property.[19]

d. **Percentage Limitation.** The final regulations limit "incidental personal property" to 15 percent of the *aggregate fair market value of all replacement real properties received in the exchange.* In responding to a requested comment that the limitation be greater than 15 percent, Treasury explained that a limitation in

---

18 Treasury declined to include incidental personal property with replacement property, which would have increased the amount of incidental personal property allowed before reaching the 15 percent threshold. [26 CFR Part 1; TD January 1, 20259935; 4830-01-p-26].

19 26 CFR Part 1; TD 9935; 4839-01-p-31.

excess of 15 percent

> might induce taxpayers to bundle more personal property with their exchanged property. Such a result 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. 85 FR 35840.[20]

e. **Fifteen Percent Rule Not a Safe Harbor.** The final regulations state that acquisition of personal property in excess of 15 percent (i) is not disregarded in determining if one of the "(g)(3)" through "(g)(5)" safe harbors[21] ceases to apply and whether the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or non-like-kind property are expressly limited as required by §1.1031(k)-1(g)(6). Nevertheless, neither do the final regulations state that exceeding the fifteen percent limit will necessarily cause the exchange to fail. In response to a request that the 15-percent limitation be designated a "safe harbor," Treasury offered a noncommittal, but

20 Treasury also noted that "[r]aising this limit. . .would further increase the tax incentives for investing in such property."

21 The 1991 deferred exchange regulations establish four "safe harbors" which allow the taxpayer to avoid actual or constructive receipt of money or other property when engaging in an exchange. They include (1) qualified intermediaries, (2) interest and growth factors, (3) qualified escrow accounts and qualified trusts, and (4) security or guaranty arrangements. §§1.1031(k)-1(g)(2)-(5). They may be used separately or in combination.

somewhat benign response, stating:

> The 15-percent limitation is not a bright-line test for determining whether a transaction fails to meet the requirements of an exchange under section 1031. All of the facts and circumstances of the taxpayer's situation are considered in determining if the exchange meets the requirements of Section 1031.

f. Fifteen Percent Rule Not to Apply on Property-by-Property Basis.

i. All Replacement Properties Considered. The final regulations clarify that the 15-percent limitation is calculated by comparing the value of all incidental personal property in the replacement properties to the value of all replacement real properties received in the same exchange. The regulations cite an example of two office buildings, one containing office furniture, the other containing no personal property. The rule stipulates that 15 percent rule applies to the value of both buildings.[22] The discretionary power of the IRS to rein in transactions based on undesirable "facts and circumstances" may itself operate as a sufficient deterrence to what the Service views as an unwarranted expansion or use of the aggregate rule.

[22] §1.1031(k)-1(c)(4) provides a limit on the number of properties, or the fair market value of the properties, a taxpayer may identify to meet the requirements of section 1031(a)(3).

ii. **Tax Consequences of 15 Percent Threshold Being Met.** If the fifteen percent threshold is not exceeded, the personal property may be *identified*"[23] as part of the exchange, and the exchange may proceed.[24] The receipt of persona property will be taxed as gain.

iii. **Pre-TCJA Personal Property Received in Exchange.** Prior to the elimination of personal property under Section 1031, taxpayers could avoid or minimize[25] boot[26] by ensuring that relinquished personal property was offset by replacement personal property. The personal property relinquished could be netted against replacement personal property to avoid gain under Section 1031. Netting will provide no benefit under TCJA since all personal property received – regardless of what is relinquished, is taxed.

iv. **The "All Replacement Property" Rule May Pose**

---

23 If the personal property component is less than 15 percent, it is not required to be separately identified. Otherwise it must be separately identified.

24 Provided the incidental personal property does not exceed 15 percent of the total fair market value of replacement real properties and incidental personal properties, no separate identification of the personal property is required. §1.1031(k)-1(c)(5).

25 Even though personal property no longer qualifies under Section 1031, tax planning is still important in situations involving Section 1245. See discussion in *Gerhardt, infra.*

26 Nonqualifying property, or "boot" may consist of (i) cash; (ii) relief from liabilities; (iii) property that could be exchanged under Section 1031, but is not of "like kind" to the relinquished property (e.g., a bridge for an option to acquire an orange grove in 15 years might not be of "like kind" even though both qualify as real property).

Risks. The "all replacement property" rule is helpful. As noted, if three properties are identified, any single replacement property may contain non-qualifying personal property in excess of 15 percent, provided the aggregate 15 percent limitation among all replacement properties is respected. However, the IRS could make the argument that if the 15 percent threshold in the aggregate is exceeded, then all replacement properties should be denied exchange treatment – even those whose personal property component is less than 15 percent. Although the Tax Court might not find the argument compelling, it is not without logic.

g. **What Are The Scope of "Commercial Transactions."** The incidental property rule refers to "commercial transactions." The final regulations state that the term "commercial transactions"

> refers to transactions involving business or investment property rather than personal property. Accordingly, the term "commercial" describes the type of transaction, not the type of property. Therefore, a commercial transaction may involve either residential or non-residential property. . . Further, the incidental property rule applies to non-real property, regardless of whether tangible or intangible.

This, together with the statement that "all of the facts and circumstances are considered" in deciphering whether the transaction qualifies under Section 1031, might suggest that the commercial transactions restriction is rather narrow in application. Still, for the restriction to have some meaning, it must have been intended to exclude *some* incidental personal property. Whatever the exact parameters of allowable personal property, and whatever the exact meaning of "commercial transactions," it seems fair to conclude that personal property entirely unrelated to the real property should not be identified. An exchange of a condominium should not be exchanged with a condominium and a car, even if car is worth less than 15 percent of the value of the condominium. Technically, even shares of common stock included in the exchange, could cause a problem under the rule. Cash, although also personal property, is not problematic for the simple reason that if it were, it would eviscerate the concept of boot, a result surely not intended by the final regulations.

h. **Hypothetical.** A syndicate seeks to acquire a racetrack and casino, together with two non-transferable licenses to operate at the racetrack location, in an exchange qualifying under Section 1031. Neither license qualifies as real property under **Example 12, i.e.,** since neither license is "for the use, enjoyment, or occupation of the [racetrack or casino], but rather a license to operate them as a business at the [racetrack] location." While both licenses appear to qualify as incidental personal property, when considered with other personal property to be included in the exchange (such as machines, furniture and racetrack equipment) the aggregate amount of incidental personal property would constitute about 20 percent. However, if the two licenses were excluded, the aggregate amount would be reduced to about 15 percent.

i. **Analysis.** Identifying the two licenses would cause the 15 percent limitation to be exceeded. Use of escrow funds to purchase all of the incidental personal property would deprive the taxpayer the benefit of the legal fiction protecting against a "(g)(6)" violation. The final regulations state that the 15 percent rule is neither a "safe harbor" nor a "bright line," and that "all of the facts and circumstances" are considered in determining whether Section 1031 applies. The percentage excess is not de minimis, but neither does it appear excessive. The final regulations articulate the concern that excess personal property not be "bundled" into an exchange, thereby "unlock[ing] a class of personal property that would no longer be 'incidental' to the real property." Violating the "(g)(6)" limitation here would present a tax risk suggesting consideration of alternatives. One would be to purchase the licenses under a separate contract.

i. **Use of Cash to Avoid Potential "(g)(6)" Issue.** To avoid the use of escrow funds to purchase nonqualifying incidental personal property, the taxpayer could purchase the licenses with outside cash under a separate contract. This would require an additional cash outlay, which might only be temporary.[27] The nonqualifying property received would still constitute boot. The use of outside cash to purchase the licenses would reduce incidental personal property and eliminate the "(g)(6)" issue. Yet perhaps the most significant concern would not be present, since the licenses are directly related to the properties. The discussion in the final regulations seems to bless use of separate contracts to transfer property related to the transfer. The phrase "the personal property" in the second sentence seems to refer to exactly the same personal property "relating" to the transfer in the first sentence. The discussion in final regulations reads:

---

[27] If borrowed funds are used to purchase those assets, post-exchange financing might allow extraction of the cash to repay the loan.

> Generally, if personal property is transferred as part of a transfer of real property, *the personal property* would be listed in the contract relating to the transfer. However, if a taxpayer lists *the personal property* in a contract separate from the contract addressing the transfer of real property, listing the personal property in a separate contract generally will not prevent the taxpayer from using the incidental property rule.[28]

i. **IRS Challenge.** Since the licenses are directly related to the real property in the exchange, they would appear to satisfy the "commercial transactions" requirement. No "(g)(6)" violation would occur, since incidental personal property would not exceed the 15 percent limit.

ii. **Violation of the Economic Substance or Business Purpose Doctrine?** The separate purchase of the licenses for cash does appear to violate either the business purpose or economic substance doctrine. The licenses purchased with cash will have a cost basis, but will still be taxable boot. Therefore, the licenses will be taxed at the same rate as the incidental personal property. No tax avoidance is present.[29] While the 15 percent limit is not a "safe harbor," the IRS could assert that the transaction should not qualify under Section 1031 based on the facts and circumstances.

---

28 26 CFR Part 1; TD 9935 [4830-01-p-32].

29 IRC §7701(o).

However, a close reading of the discussion in the regulations regarding separate contracts seems to immunize the transaction to some extent. The licenses relate to the larger asset, which is also a positive factor. Viewed in its entirety, the transaction is not an attempt to "bundle" excess personal property into the exchange. Requiring the taxpayer to include the licenses in the exchange is treating the licenses more harshly than other "boot," which seems inappropriate. While treating the licenses as boot rather than including them as personal property does facilitate qualification under Section 1031, there is arguably no more of a tax-avoidance purpose than exists with garden-variety estate planning. As stated by Learned Hand:

> Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury. There is not even a patriotic duty to increase one's taxes.

(1) **Conclusion.** While there appears to be some risk in using outside cash to purchase the licenses, the risk appears to be manageable,[30] since several factors weigh in favor of the taxpayer.

---

[30] Consider, for example, Rev. Proc. 2001-28, which requires that for purposes of obtaining an advance ruling, the lessor must have a minimum "at risk" investment in property of at least 20 percent of the cost of the property for a leveraged lease to be respected as such, rather than to be treated as a conditional sales contract. The 20 percent figure has been viewed more in the nature of a guideline in some cases.

j. **"Distinct Asset" Rule Does Not Affect 3-Property Identification Rule.**[31] Reg. §1.1031(k)-1(c)(4)(i)(A) limits a taxpayer to the identification of three replacement properties (three-property rule). The final regulations clarify that although each "distinct asset" is analyzed separately, the distinct asset rule applies only for the purposes of determining whether an asset is real property under Section 1031. It has no effect on the three-property rule.[32]

7. **Final Regulations Definition of Real Property**[33]**.** Under the final regulations, real property consists of land and improvements to land[34], unsevered natural products of land[35], and water and air space superjacent

---

31 The identification rules allow the identification of (i) up to three properties, regardless of their respective fair market values; (ii) any number of properties, provided their aggregate fair market value does not exceed 200 percent of the fair market value of the relinquished property; (iii) any number of properties the taxpayer actually closes on within the 45-day identification period; or if risk is acceptable (iv) any number of properties, provided the taxpayer actually closes on properties whose fair market value equals or exceed 95 percent of the fair market value of properties identified.

32 Final Regs. §1.1031(k)-1(c)(5).

33 Final Regs. §1.1031(a)-3(a).

34 Final Regs. §1.1031(a)-3(a)(3).

35 Final Regs. §1.1031(a)-3(a)(2)(ii); **Example 1,** *Natural products of land,* discusses "fruit bearing plants" harvested annually. The unsevered lants are natural products of the land and constitute real property. Upon being harvested, the fruit ceases to be part of the land is not real property.

to land[36], intangible interests in real property[37], and real property under state or local law.[38] **<u>All real property must be (or qualify as) a "distinct asset</u>."**[39]

8. **"Inherently Permanent Structures."**[40] An inherently permanent structure (IPS) is any building or other structure that is a distinct asset and is permanently affixed to real property and that will ordinarily remain affixed for an indefinite period of time. Affixation is considered permanent if reasonably expected to last indefinitely based on all the facts and circumstances.

   a. **Buildings and "Listed" Examples of Inherently Permanent Structures.** A building is any structure or edifice enclosing a space within its walls, and covered by a roof to provide shelter or housing, or to provide working, office, parking, display, or sales space. Buildings include the following distinct assets if permanently affixed: Houses, apartments, hotels, motels, enclosed stadiums and arenas, enclosed shopping malls, factories and office

---

36 Final Regs. §1.1031(a)-3(a)(2)(ii) **Example 2**, *Water superjacent to land*, provides: B owns a marina comprised of U-shaped boat slips and end ties. The U-shaped boat slips are spaces on the water that are surrounded by a dock on three sides. The end ties are spaces on the water at the end of a slip or on a long, straight dock. B rents the boat slips and end ties to boat owners. The boat slips and end ties are water space superjacent to land and thus are real property within the meaning of paragraph (a)(1) of this section.

37 Final Regs. §1.1031(a)(3)-3(a)(5).

38 Final Regs. §1.1031(a)-3(a)(1).

39 Final Regs. §1.1031(a)(4).

40 Final Regs. §1.1031(a)-3(a)(2)(ii)(A).

buildings, warehouses, barns, enclosed garages, enclosed transportation stations and terminals, and stores.[41]

b. **"Other" Inherently Permanent Structures.** Other inherently permanent structures (OIPS) include the following distinct assets, if permanently affixed: in-ground swimming pools; roads; bridges; tunnels; paved parking areas, parking facilities, and other pavements; special foundations, 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 platforms, derricks, oil and gas storage tanks; and grain storage bins and silos. Affixation to real property may be accomplished by weight alone.[42]

c. **Importance of "Affixation."** Inherently permanent structures, other inherently permanent structures, and structural components of inherently permanent structures must be permanently affixed to real property,[43] and be reasonably expected to remain permanently affixed. The final regulations provide that affixation of "other" inherently permanent structures can be achieved by weight alone (e.g., "oil storage tank").

---

41 Final Regs. §1.1031(a)-3(a)(2)(ii)(B).

42 Final Regs. §1.1031(a)-3(a)(2)(ii)(C).

43 The final regulations require consideration of "any factors suggesting that the expected period of affixation is not indefinite." Nonetheless, the final regulations emphasize all of the factors should be considered when making a determination. §1.1031(a)-3(a)(7).

d. **"Listed" IPSs and OIPSs.** All "listed" IPS and listed OIPS assets are distinct assets <u>and</u> real property per se.

i. Non-listed IPS and OIPSs are distinct assets per se.

ii. Non-listed IPSs and OIPSs must satisfy a test to qualify as real property.[44]

e. **Real Property Facts and Circumstances Test for Non-Listed Inherently Permanent Structures and Other Inherently Permanent Structures.**[45] Property not "listed" as an IPS or OIPS may qualify as real property under a test that considers the following factors:

i. The manner in which the asset is affixed to real property;
ii. Whether the distinct asset is designed to be removed or to remain in place;
iii.
iv. The damage that removal of the distinct asset would cause to the item itself or to the real property to which it is affixed;
v. Any circumstances that suggest the expected period of affixation is not indefinite; and
vi. The time and expense required to move the distinct asset.

(1) **Illustration.** Yankee Stadium does not qualify as an

---

44 If a non-listed structural component (the only asset that is not a distinct asset per se) fails to qualify as a distinct asset, it cannot real property. This is true even if the non-listed structural component would hypothetically qualify as real property under the real property facts and circumstances for non-listed structural components.

45 Final Regs. §1.1031(a)(3)-3(a)(2)(ii)(C).

inherently permanent structure because it is not an "enclosed stadium," which is a "listed asset." Assets listed under "other"inherently permanent structures do not include stadiums. Therefore, reference to the test for inherently permanent structures and "other" inherently permanent structures must be made. Yankee Stadium qualifies under the real property facts and circumstances test for IPSs and OIPSs: It is a distinct asset[46], permanently affixed; designed to remain in place; its removal would destroy the asset; and there are no circumstances suggesting that the expected period of affixation is not permanent.

9. Examples in Final Regulations of Inherently Permanent Structures.

a. Example 3: Indoor Sculpture (Passes test; real property). C owns an office building and a large sculpture in the atrium of the building. The sculpture measures 30 feet tall by 18 feet wide and weighs five tons. The building was specifically designed to support the sculpture, which is permanently affixed to the building by supports embedded in the building's foundation. The sculpture was constructed within the building. Removal would be costly and time consuming and would destroy the sculpture. The sculpture is reasonably expected to remain in the building indefinitely. As an inherently permanent structure, the sculpture is by definition a distinct asset. Since the sculpture is not listed, the a facts and circumstances test must be used to determine whether the sculpture is real property.

---

46 All inherently permanent structures and "other" inherently permanent structures are distinct assets per se.

i. **Analysis.** Since the sculpture is an inherently permanent structure, it is a distinct asset. Since the sculpture is not a listed asset, it must satisfy a facts and circumstances test to qualify as real property. The sculpture is permanently affixed to the building by supports embedded in the building's foundation, and removal would damage both the building and sculpture. The sculpture is expected to remain in place in definitely. Significant time and expense would be required to remove the sculpture. **Example 3** concludes that the factors all support the conclusion that the sculpture is an inherently permanent structure and real property.

b. **Example 4: Bus Shelters (Fails test; not real property).** D owns 400 bus shelters, each of which consists of four posts, a roof, and panels enclosing two or three sides. Each bus shelter is prefabricated from steel and is bolted to the sidewalk. Bus shelters are disassembled and moved when bus routes change. Moving a bus shelter takes less than a day and does not damage either the bus shelter or sidewalk to which it was affixed. The bus shelters are not permanently affixed and are not buildings or other inherently permanent structures (OIPSS). The bus shelters must be analyzed to determine whether they are real property.

(1) **Conclusion.** The bus shelters are not permanently affixed to the land and are not inherently permanent structures. They are designed to be removed and not remain in place indefinitely. They would not be damaged if removed and would not damage the sidewalks to which they are affixed. They will not remain affixed indefinitely, and would not require significant time and expense to move. Therefore, the bus shelters are not inherently permanent structures and are not real property.

10. **Structural Components of Inherently Permanent Structures.**[47] A structural component means any distinct asset that is a constituent part of, and integrated into, an inherently permanent structure.

   a. **Examples of Listed Structural Components.** Structural components include the following distinct listed assets, 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.[48]

   b. **Listed Structural Components Are Distinct Assets & Real Property Per Se.** Listed structural components of IPSs are distinct assets <u>and</u> real property per se.

      i. **Non-Listed Structural Components.** Non-listed structural components of inherently permanent structures must satisfy both a distinct asset[49] facts and circumstances test as well as a real property facts and circumstances test to qualify as real property.[50]

---

47 Final Regs. §1.1031(a)(3)-3(a)(2)(iii)(A).

48 Final Regs. §1.1031(a)(3)-3(a)(2)(iii)(B).

49 The distinct asset test for structural components is discussed *infra*.

50 If an asset is not a distinct asset, it cannot qualify as real property.

c. **Real Property Facts and Circumstances Test for Non-Listed Structural Components of Inherently Permanent Structures.**[51] If a component of a building or inherently permanent structure is a distinct asset and is not listed as a structural component, the determination of whether the component is real property is based on the following facts and circumstances, which consider

- **i.** the manner, time, and expense of installing removing the component;
- **ii.** whether the component is designed to be moved
- **iii.** 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
- **iv.** whether the component is installed during construction of the inherently permanent structure.

d. **Interconnected Assets.** If interconnected assets work together to serve an inherently permanent structure (for example, systems that provide a building with electricity, heat, or water), the assets are analyzed together as one distinct asset that may be a structural component. A structural component may qualify as real property only if the taxpayer holds its interest in the structural component together with a real property interest in the space in the inherently permanent structure served by the structural component.[52]

11. **Distinct Assets.** All real property must be a "distinct asset." However, only non-listed structural components are not distinct assets per se. Therefore, only non-listed structural components must qualify under the

---

[51] Final Regs. §1.1031(a)(3)-3(a)(2)(iii)(B).

[52] §1.1031(a)-3(a)(2)(iii).

facts and circumstances test.

a. **Inherently Permanent Structures.** All inherently permanent structures and "other" inherently permanent structures are distinct assets per se, whether or not listed. Listed structural components of inherently permanent structures are also distinct assets per se.

b. **Non-Listed Structural Components.** Non-Listed structural components may qualify as distinct asset under a facts and circumstances test.

c. **Distinct Asset Facts and Circumstances Test for Non-Listed Structural Components.** The distinct asset test for non-listed structural components considers the following factors:

   i. Whether the item is customarily sold or acquired as a single unit rather than as a component part of a larger asset;
   ii. whether the item can be separated from a larger asset, and if so, the cost of separating the item from the larger asset;
   iii. whether the item is commonly viewed as serving a useful function independent of the larger asset of which it is a part; and
   iv. whether separating the item from a larger asset of which it is a part impairs the functionality of the larger asset.

d. **Each Distinct Asset Analyzed Separately.** The final regulations provide that each "distinct asset"

> is analyzed separately from any other assets to which the asset relates to determine if the asset is real property, whether as land, an inherently permanent

structure, or a structural component of an inherently permanent structure. Buildings and other inherently permanent structures are distinct assets. Assets and systems listed as a structural component in paragraph (a)(2)(iii)(B) of this section are treated as distinct assets.

e. **Interconnected Assets.** Under the final regulations, if interconnected assets work together to serve an inherently permanent structure (e.g., systems that provide a building with electricity, heat, or water), the assets should be analyzed together as one distinct asset that may qualify as a structural component of real property.[53]

12. **Examples in Final Regulations Illustrating Structural Components.**

a. **Example 5: 3D Printer (passes test; real property).** E owns a building that it uses in its trade or business of manufacturing airplane parts. The building includes an industrial 3D printer that can print airplane wings and an electrical generator that serves the building and the 3D printer in a backup capacity. The 3D printer weighs 12 tons, is designed to remain in

---

[53] §1.1031(a)-3(a)(2)(iii). The requirement relates to *the interrelationship among distinct assets*. A structural component and the larger asset to which it relates may each be distinct assets, but for purposes of administrative convenience they may be considered as one distinct asset. It is possible to imagine cases where a surfeit of structural components – such as would exist with a nuclear reactor – might make it a logistical nightmare to treat each structural component as a separate distinct asset, rather than them as part of the larger distinct asset to which it relates.

place indefinitely once installed in the building. Its removal would be time-consuming and very costly, and would cause significant damage to the building. The 3D printer was installed during building construction. The generator was also installed during construction and is designed to remain in place indefinitely once installed. Although costly and time-consuming to remove, removal of the generator would not result in substantial damage to the generator or the building.

i. **Analysis:** The 3D printer is not listed as a structural component of an IPS. Therefore, real property determination depends on qualification under real property the facts and circumstances test for structural components.[54] The 3D printer (1) would be time-consuming and costly to remove; (2) is not designed to be moved; (3) would damage the building if removed; and (4) was installed during building construction. Example 5 concludes that the 3D printer is a structural component of the building and real property.

ii. **Observation:** The 3D Printer illustrates an example where machinery has been elevated to the status of real property under the final regulations. This is a departure from the proposed regulations, which would not have treated the printer as real property. Note the importance of "integration": The 3D printer sitting in a Fedex warehouse for delivery would not qualify as real property under the facts and circumstances test. To qualify, the 3D printer must be a "<u>constituent part of, and integrated into, an</u>

54 The example appears to assume that the 3D printer qualifies as a distinct asset.

inherently permanent structure."[55] The facts and circumstances test elaborates upon the basic regulatory requirements and elicits further facts including the circumstances of installation, permanency, and difficulty and effect of the asset's removal in order to determine whether the non-listed asset qualifies as real property.

iii. **Status of Generator.** The electrical generator is also not listed as an example of a structural component of an inherently permanent structure. Therefore, it must be analyzed under the same test as the 3D printer.

(1) **Analysis.** Like the 3D printer, removal of the electrical generator would be time-consuming and costly. The generator is not designed to be moved. However, its removal would not damage the generator or the building. Like the 3D printer, the generator was installed during building construction.

(2) **Conclusion.** Example 5 concludes that the factors in the aggregate support the conclusion that the electrical generator is a structural component of the building and real property. Although removal would not cause significant damage to either the generator or the building, that factor does not outweigh the others which support the opposite conclusion. Therefore, the generator is real property.

b. **Example 6: Raised Flooring For Industrial 3D Printer (not a structural component; not real property).** The facts are the same as those for the Example 5, except that E, when

55 §1.1031(a)-3(a)(iii)(A).

installing its 3D printer, also installed a raised flooring system for the purpose of facilitating the operation of the 3D printer. The raised flooring system is not designed or constructed to remain permanently in place. Rather, the raised flooring system can be removed, without any substantial damage to the system itself or to the building, and then reused. The raised flooring was installed during the building's construction.

i. **Floors Appear Under List of Structural Components.** Although floors are listed as an example of a structural component, the raised flooring system installed to facilitate the operation of the 3D printer is not a constituent part of, and integrated into, an inherently permanent structure as required, and therefore is not flooring as listed. Thus, the raised flooring must be analyzto determine whether it is a structural component of the building using the factors provided. The raised flooring—(A) is installed and removed quickly and with little expense; (B) is designed to be moved and is not designed specifically for the particular building of which it is a part; (C) is not damaged, and the building is not damaged, upon its removal; and (D) was installed during construction of the building.

ii. **Analysis.** The factors considered in the aggregate support the conclusion that the raised flooring is not a structural component of the building. Although the raised flooring was installed during building construction, that factor does not outweigh the factors supporting the conclusion that the flooring is not a structural component. Therefore, the raised flooring is not real property.

c. **Example 7: Steam Turbine (structural component; real property).** F owns a building with a large steam turbine attached as a fixture to the building. The steam turbine is a component of a system used for the commercial production of electricity for sale to customers in the ordinary course of F's business as an electric utility. The steam turbine also generates electricity for the building. The steam turbine takes up a substantial portion of the building and is designed to remain in place indefinitely once installed. The steam turbine was installed during building construction and its removal would be costly and cause damage to the building. The steam turbine is not listed as a structural component and must be analyzed under the facts and circumstances test.

i. **Facts and Circumstances Test.** The steam turbine (A) is costly to remove from the building in which it is located;(B) is not designed to be moved;(C) if removed, would cause damage to the building; and (D) was installed during building construction. The factors support the conclusion that the steam turbine is a structural component of the building and therefore real property.

d. **Example 8: Partitions.** G owns an office building that it leases to tenants. The building includes partitions owned by G that are used to delineate space within the building. The office building has two types of partition systems: A conventional partition system and a modular partition system. Neither was installed during building construction. Both are distinct assets.

i. **Conventional Partition System (structural component, real property).** The conventional system may remain in place when a tenant vacates the premises, and is integrated into the office building and is designed and constructed to remain in areas not subject to reconfiguration or expansion. It can be removed only by demolition, and once removed cannot be reused. Removal would cause substantial damage to the conventional system itself, but would not cause substantial damage to the building. The conventional partition system is comprised of walls that are integrated into an inherently permanent structure and are listed as structural components. Thus, the conventional partition system is real property.

ii. **Modular Partition Systems (not real property).** Modular systems are typically removed when a tenant vacates the premises. They are not designed or constructed to remain permanently in place, but rather to be movable. Each modular system can be readily removed, is not damaged by removal, and can be reused. Removal does not cause substantial damage to the modular system or the building, and may be moved to accommodate configurations of various tenants. The modular system is not integrated into the building and is therefore not a listed asset. Application of the factors provided in the facts and circumstances test supports the conclusion that the modular system is not real property.

e. **Example 9. Pipeline Transmission System.** The system transports natural gas from facilities to end users. It is comprised of underground pipelines, isolation valves and vents, pressure control and relief valves, meters, and compressors. Each of these distinct assets was installed during pipeline construction and was designed to remain permanently in place.

(1) **Pipelines.** The oil and gas pipelines are listed in the category of other inherently permanent structures.

Therefore, they are real property.

(2) **Isolation Valves and Vents and Pressure Control and Relief Valves.** These items are not listed and must be analyzed under the facts and circumstances test for structural components. Evaluation of the factors indicates the following: (1) (*costly to remove?*) The isolation valves and vents are time consuming and expensive to install; (2) *(designed to be moved?)* they are designed specifically for the particular pipelines of which they are a part; (3) (*damage to component or asset to which attached if removed?*) they will sustain damage and damage the pipelines if removed; and (4) (*installed during construction of IPS?*) they were installed during pipeline construction.

(a) **Conclusion: Real property.** Since they were installed during pipeline construction and were designed to remain in place, they are real property.

(3) **Meters and Compressors. Conclusion: Not real property.** Although installed during pipeline construction, "unlike other types of meters and compressors, these particular meters and compressors are not time consuming to install and remove," and are not designed specifically for the pipelines used, and would cause no damage if removed. Therefore, they are not structural components as defined in the section, and are not real property.

13. **Unsevered Natural Products of Land.** Unsevered natural products of land include growing crops, plants, and timber; mines, wells, and other natural deposits are real property. However, natural products and deposits, such as crops, timber, water, ores, and minerals, cease to be real property when they are severed, extracted, or removed from the land.

    a. **Example 1.** A owns land with perennial fruit-bearing plants that A harvests annually. The unsevered plants are natural products of the land and thus are real property for purposes of section 1031. A annually harvests fruit from the plants. Upon severance from the land, the harvested fruit ceases to be part of the land and therefore is not real property. Storage of the harvested fruit upon or within real property does not cause the harvested fruit to be real property.

14. **Intangible Assets Defined As Real Property.** TCJA eliminated the ability to exchange intangible personal property, such as patents or copyrights. The final regulations provide that intangible property may qualify as real property if the intangible interest derives its value from real property or an interest in real property and is inseparable from that real property or interest in real property.[56] The final regulations state

> As a result, 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 section 1031 purposes. However, the purpose of the intangible

[56] §1.1031(a)-3(a)(5)(ii).

property remains relevant to the real property determination. State or local law may also provide that an intangible asset is real property.

Note that qualification as real property is necessary, but not sufficient under Section 1031. Intangible property relinquished must also be of "like kind" to the replacement property.

a. **Qualifying Intangible Assets.** Intangible assets qualifying as real property include fee ownership; co-ownership; a leasehold; an option to acquire real property; an easement; stock in a coop, land development rights and "similar interests in real property." Regs §1.1031(a)-1(c) cite as examples of qualifying exchanges (i) city real estate for a ranch or farm; (ii) a leasehold with 30 or more years to run with a fee; (iii) improved real estate for unimproved real estate.

   i. **Example 11.** Taxpayer receives a special use permit from the government to place a cell tower on government land adjacent to a federal interstate. Government regulations provide that the permit is not a "lease" but a permit to use the land for a cell tower. Under the permit, the government reserves the right to cancel the permit and compensate taxpayer if the property is needed for a higher public purpose. The permit is in the nature of a leasehold and therefore qualifies as real property.

b. **State Law Has No Relevance in "Like Kind" Determination.** State law may characterize intangible property such as easements, water rights, or mineral rights as real property. Under the final regulations, those determination would result in qualification under Section 1031 regardless of any classification under the distinct asset-inherently permanent structure system employed in the final regulations. However, whether real property interests in those items or any others are of "like kind" is solely within the province of federal tax law, and would be decided based on existing precedent or IRS ruling.

c. **Fee Ownership and Co-Ownership.**

i. **Coop Shares and Land Development Rights.** These intangible assets have historically been characterized as real property, and are expressly described as real property in the final regulations. PLR 202335002 stated that an exchange of a fee interest for land development rights in real estate qualified as a like kind exchange. PLR 200631021 stated that New York coops are of like kind to other real property."[57]

d. **Leases and Easements.** Regs. §1.1031(a)-1(c) provide that a lease of 30 years or more qualify as real property. PLR 9851059 opined that an exchange of agricultural easements over two farms for fee simple interests in a different farm were of "like kind."

e. **Licenses and Permits.** The final regulations provide that some licenses and permits qualify as real property, while others do not: "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, easement, or

[57] The PLR stated that while "New York case law might suggest that there are conflicts concerning whether a cooperative interest in real property is real property. . . . various New York statutes treat an interest in a cooperative as equivalent to an interest in real property." The PLR stated that interests in cooperative apartments in New York are of like kind to improved and unimproved realty.

other similar right, generally is an interest in real property. . .However, a license or permit to engage in or operate a business on real property is not real property or an interest in real property, regardless of its classification under State or local law."[58]

f. **Options to Acquire Real Property.** The final regulations provide that an option to acquire real property is real property for purposes of Section 1031. Field Service Advisory 1995-12 stated that an option to acquire real estate was of like kind to real estate, since the taxpayer's money was "inextricably connected" with real property of like kind.[59] Whether a fee interest is of 'like kind" to 3option in a particular case depends on whether the two assets are of the same "nature or character."[60] Earlier case law equated options to fee interests.[61] It is unclear whether an option to acquire real property in the future is of like kind to real property. Or

---

58 Final Regs. §1.1031(a)-5(ii).

59 IRS Counsel opined:

> Your doubt as to the applicability of section 1031 apparently centers upon whether exchanging land for an option to acquire land constitutes a like kind exchange. We do not view that as the disqualifying aspect . . . While at its root the transaction appears to involve the exchange of land for an option to acquire land, it would be contrary to Service position to challenge nonrecognition of the swap on that basis.

60 Final Treas. Reg. §1.1031(a)-3(a)(5).

61 The seminal case of *Starker v. U.S.*, 602 F2d 1341 (9th Cir. 1979), which first sanctioned non-simultaneous exchanges, held that "a contractual right to assume the rights of ownership [was no different than] ownership rights themselves." This implies that an option is of the same "nature of character" to a fee interest.

whether an option to acquire real property in a week is of like kind to an option to acquire real property in a year.

15. Shares in a mutual ditch, reservoir or irrigation company.

16. Cases, Rulings, and Pronouncements of Note.

a. *Gluck v. Commissioner.* T.C. Memo 2020-66.

i. **Facts.** *Gluck*, a practicing real estate attorney in Manhattan, claimed like kind exchange treatment when reporting the sale of a $10.2 million New York condo. The replacement property consisted of an interest in a partnership[62], which could not be exchanged under Section 1031. Gluck made several unconvincing arguments and the record did not dispute that despite being a real estate attorney, *Gluck* may have mistakenly believed that the replacement property qualified under Section 1031. *Gluck* may also have been under the impression that the replacement property consisted of several separate tenancies in common. (However, even if this were true, it is quite difficult for owners of tenancy in common units to avoid partnership status for tax purposes.) In any event, the partnership filed Form 1065, thus "declaring" itself as a partnership for tax purposes.

---

62 The Tax Reform Act of 1984 amended Section 1031 to exclude partnership interests from qualifying for exchange treatment. Note that an LLC or a partnership can *itself* engage in a like kind exchange. In addition, single-member LLCs, disregarded for federal income tax purposes, may engage in exchanges, and are often used to hold property being exchanged, in part due to their being a "bankruptcy remote entity."

ii. **Holding.** The Court agreed with the Commissioner that if *Gluck* believed that what he acquired was not a partnership interest, he should have filed a form 8082 Notice of Inconsistent Treatment, allowing the IRS to audit the partnership to determine if *Gluck* was correct. *Gluck* also argued that the Notice of Deficiency was misleading, since although it stated that he had 90 days to file a petition for a "redetermination" of the deficiency, the Court determined that it was without jurisdiction to redetermine the deficiency. To make the matters worse for *Gluck*, since the adjustment was "computational," it could be assessed by the Court.

iii. **Penalties.** The Tax Court also imposed a negligence penalty, finding that deficiency procedures did not apply to the imposition of accuracy-related penalties. The Court also held *Gluck* to a higher standard since he was a real estate attorney. Partners who dispute the accuracy of a Schedule K-1 should contact the partnership to correct the error, if one exists. If the error is at the partnership level, then the IRS must audit the partnership for the Tax Court to acquire jurisdiction.

b. **PLR 202124008.** The issue was whether an exchange of Bitcoin for Litecoin and two other exchanges involving digital currency qualified as like kind exchanges. The ruling predated TJCA. Even so, the Ruling is helpful because it examines the "like kind" requirement involving intangible property.

i. **Crypto "Pairs" Were of a Different "Nature or Character."** The Ruling cited Notice 2014-21 and stated "virtual" currency is considered property for federal income tax purposes. The Ruling noted that cryptocurrency exchanges may involve "trading pairs." Bitcoin and Ether "typically" may be traded for other crypto currencies. They act as an "on ramp" and "off ramp" for other crypto currencies. Thus, Bitcoin and Ether play a "fundamentally different role" than other crypto currencies. The PLR cited the example of an exchange of gold for silver which resulted in partial gain because gold was primarily used as an investment, while silver was used as an industrial commodity. Under Regs. §1.1031(a)-1(b) "like kind" refers to the nature or character of the property and not the "grade or quality." Since the crypto currency "pairs" at issue were of a different nature or character, those pairs did not qualify for exchange treatment under Section 1031.

c. **PLR 202309007.** The ruling involved water rights. A group of ranch owners owned separate contiguous fee interests in farmland adjacent to a river from which water was diverted pursuant to a license. The ranch owners were successors in interest to an original "founder." Although the acreage owned by each ranch owner differed, each was allowed full access to water, and was allowed to divert water under the license. The license permitted a fixed volume of water to be diverted during each "diversion season." The ranch owners agreed that if all or a portion of the water rights were sold (by any ranch owner), the proceeds would be divided in accordance with the ranch owners' relative percentage land ownership. The facts of the Ruling:

i. Taxpayer, a ranch owner, desired to sell a portion of his license and report the sale under Section 1031. The IRS analyzed the transaction as follows:

ii. Regs. §1.1031(a)-1(b) provides that the term "like kind" refers to the "nature of character" of the property and not to its "grade or quality." One "kind or class" of property may not be exchanged for property of a different kind or class.

iii. Regs. §1.1031(a)-1(c)(2) provides that the following exchanges are of "like kind": (i) city real estate for a farm; (ii) a 30 year lease for real estate; and (iii) unimproved real estate for improved real estate.

iv. Regs. §1.1031(a)-3(a)(1) defines "real property" as land and improvements to land, unsevered products of land, and water and air space superjacent to land. The ruling continues and states "Property that is real property under State or local law . . . is real property for purposes of §1031."

v. Regs. §1031(a)-3(a)(5)(i) furnishes a list of intangible assets that are real property for purposes of §1031. That list includes, for example, leaseholds and options to acquire real estate, but does not specifically mention water rights. However, the final regulations state that "[s]imilar interests are real property for purposes of §1031 if the intangible asset derives its value from the real property or interest and is inseparable from the real property or interest in real property." The paragraph concludes by noting, inter alia, that a license for the "use, enjoyment, or occupation of land" in the nature of a "leasehold, easement, or similar right," is generally an interest in real property.[63]

vi. Rev. Rul. 55-749 concluded that an exchange of land for "perpetual" water rights that were considered real property

---

63 PLR 9601046 held that conservation easements are of like kind to a fee interest in real estate where state law provided that the easement constituted an interest in real property.

under state law and were (i) not limited to a specific amount of water or (2) for a limited period," were "sufficiently similar" as to constitute like-kind property.

vii. However, in *Wiechens v. U.S.*, 338 F.Supp.2d 1080 (D. Az. 2002), the taxpayers conveyed water rights limited in duration for 50 years, and limited in quantity to a specific percentage of "overall supply of agricultural water," for a fee interest in farmland. The District Court ruled that the interests were not of like kind, finding that the "nature and character" of the transferred rights were not "substantially alike." Specifically, the Court found that the water rights were "narrowly restricted in priority, quantity, and duration."

viii. In the last paragraph of its analysis, the Ruling found that "cited cases and case law" support the characterization of water rights as real property. The Ruling then addressed the problem in *Weichens*. It noted that the water rights in the Ruling request (i) grant the ranch owners a "set volume" of water each season; (ii) are not dependent "on anything other than the physical presence of water in River;" and (iii) are perpetual.

ix. The Ruling concluded that the water rights were of like kind to a fee simple interest.

d. **PLR 202335002.** The ruling stated that Transferable Development Rights (TDRs) were of like kind to a fee interest in real property.[64] The taxpayer owned two properties through single-

64 In PLR 200901020, taxpayer sold land to buyer for cash. As part of the consideration the taxpayer also received put options giving

member LLCs. It intended to purchase TDRs to facilitate new development of a building in one of the properties. The TDRs would be sold by the city, with the cash funding construction of a public park. The taxpayer would use the TDRs to bypass otherwise applicable zoning restrictions to facilitate building development. The transaction was structured as an "exchange last reverse exchange" involving an exchange accommodation titleholder (EAT).[65] Under Regs. §1.1031(a)-3(a)(5)(i), land development

---

taxpayer the right to transfer residential development rights to the buyer. If taxpayer exercised the put option and transferred development rights to buyer, then buyer would be required to transfer to taxpayer certain approved hotel development rights. The PLR stated that that development rights were of like kind to (i) a fee interests; (ii) a leasehold interest of greater than 30 years; and (iii) land use rights.

65 An "exchange last" reverse exchange permits the taxpayer's accommodator ("EAT") to acquire replacement property on the taxpayer's behalf, and hold it for up to 180 days. The taxpayer must identify property to be relinquished within 45 days, and close on that relinquished property within 180 days. In PLR 2002335002, the replacement property consisted of the TDRs. An "exchange last" reverse exchange is useful when the choice of replacement property is clear, but the taxpayer is undecided as to which property (or properties) to relinquish.

An "exchange first" reverse exchange may occur where both the relinquished and replacement properties have been determined, but no buyer has been found for the relinquished property. This could occur where the intended purchaser of the relinquished property defaults and the taxpayer is already committed to closing on the replacement property. The taxpayer would immediately takes title to the replacement property. The accommodator ("EAT") purchases the taxpayer's relinquished property and parks it for up to 180 days, until the taxpayer finds a new buyer. Although more complex and costly than deferred exchanges, reverse exchanges can preserve rights are considered real property for purposes of Section 1031. The final regulations did not address "like kind" issues. Pre-2020 Private Letter Rulings have stated that some land development rights are of like kind to a fee interest.[66]

i. The two properties were designated DE 1 and DE 2 (i.e., disregarded entity 1 and disregarded entity 2). As part of the intended reverse exchange, DE2 will loan funds to an EAT to purchase TDRs. To complete the reverse exchange, DE 1 will sell its property through a QI. The QI will transfer proceeds to the EAT. The EAT will repay the loan from DE 2. The TDRs will be transferred directly to DE 2.

ii. The ruling cited Rev. Rul. 68-394, in which the taxpayer's land was condemned for a freeway. The taxpayer in that Ruling also owned adjacent land leased to a second party to develop a mobile trailer park site. To replace the condemned property, the taxpayer used part of the condemnation proceeds to purchase the outstanding lease. The Ruling noted that the acquisition of a 30-year leasehold interest following the condemnation of unimproved real estate would qualify as replacement property, even though the leasehold interest was on property already owned by the taxpayer. Therefore, the ruling concluded that TDRs may qualify as like kind for purposes of IRC §1031, notwithstanding that the taxpayer intended to use the TDRs on land owned by the taxpayer prior to the acquisition of the TDRs.

---

exchanges that might otherwise fail.

66 PLR 200605102 and PLR 200901020.

---

e. ***Malulani Group, Limited and Subsidiary v. CIR,*** TC Memo 2016-209; *aff'd* No. 16-73959 (9th Cir. 2019). Although the economic substance doctrine codified in IRC §7701(o) is not mentioned by the Tax Court, its growing influence is beginning to be felt. The statute provides that a transaction entered into for profit will have economic substance only if (i) the transaction changes in a meaningful way (apart from federal tax consequences) the taxpayer's economic position; and (ii) the taxpayer has a substantial purpose, (other than tax) for entering into the transaction. Stated differently, the transaction must have a profit expectation (apart from tax), and there must be a business purpose for the transaction (apart from tax). They are considered the "objective" and "subjective" components of the doctrine, respectively. IRC §1031(f) provides rules for exchanges between "related persons."[67]

---

[67] **(f) SPECIAL RULES FOR EXCHANGES BETWEEN RELATED PERSONS**

(1) IN GENERAL

If—

(A) a taxpayer exchanges property with a related person,

(B) there is nonrecognition of gain or loss to the taxpayer under this section with respect to the exchange of such property (determined without regard to this subsection), and

(C) before the date 2 years after the date of the last transfer which was part of such exchange—

(i) the related person disposes of such property, or

(ii) the taxpayer disposes of the property received in the exchange from the related person which was of like kind to the property transferred by the taxpayer,

there shall be no nonrecognition of gain or loss under this section to the taxpayer with respect to such exchange; except that any gain or loss recognized by the taxpayer by reason of this subsection shall be taken into account as of the date on which the disposition referred to in subparagraph (C) occurs.

---

i. IRC §1031(f)(4) provides that Section 1031 "shall not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of this subsection."

ii. The taxpayer corporation sold property to an unrelated party through a qualified intermediary and completed the first leg of a like kind exchange. Within the 45 day identification period, the taxpayer identified three properties owned by a related corporation. (The Tax Court determined that had taxpayer instead sold the property to an unrelated third party, a deal that apparently fell through, it would have recognized about $1.9 million in gain.)

---

(2) CERTAIN DISPOSITIONS NOT TAKEN INTO ACCOUNT
For purposes of paragraph (1)(C), there shall not be taken into account any disposition—
(A) after the earlier of the death of the taxpayer or the death of the related person,
(B) in a compulsory or involuntary conversion (within the meaning of section 1033) if the exchange occurred before the threat or imminence of such conversion, or
(C) with respect to which it is established to the satisfaction of the Secretary that neither the exchange nor such disposition had as one of its principal purposes the avoidance of Federal income tax.

(3) RELATED PERSON
For purposes of this subsection, the term "related person" means any person bearing a relationship to the taxpayer described in section 267(b) or 707(b)(1).

(4) TREATMENT OF CERTAIN TRANSACTIONS
This section shall not apply to any exchange which is part of a transaction (or series of transactions) structured to avoid the purposes of the purposes of this subsection.

iii. The taxpayer used the proceeds from the sale of the relinquished property, now held by the qualified intermediary, to purchase three properties from related corporation. The property the taxpayer disposed of in the like kind exchange had a high basis. The property acquired from the related party had a low basis. The related corporation recognized gain of about \$3 million. However, the \$3 million gain was almost entirely offset by NOLs. (There was no violation of §1031(f)(1)(C), since the taxpayer did not dispose of property acquired in the exchange within 2-years of the date of the last transfer.)

iv. The taxpayer argued that since there was no "basis shifting," the transaction was not structured to avoid tax. However, the Tax Court, citing to *Teruya Bros*[68], found that basis-

68 In *Teruya Brothers Ltd. v. Com'r*, 124 T.C. No. 4 (2005), the Tax Court found the transaction constituted a taxable sale rather than a deferred exchange, since it had been structured to avoid the purpose of Section 1031(f). *Teruya*, in a series of transactions, transferred several properties to a QI, which sold them to unrelated parties. The QI used the proceeds to purchase replacement properties from a corporation related to the taxpayer. Although the corporation recognized more gain on its sale than the taxpayer deferred, large NOLs offset the gain. The Tax Court held the non-tax-avoidance exception of §1031(f)(2)(C) was inapplicable, since *Teruya* had "decreased their investment in real property by approximately \$13.4 million, and increased their cash position by the same amount." *Teruya* had effectively "cashed out" of its investment. Noting that *Teruya* could have achieved the same property disposition through "far simpler means," the court observed that the transactions "took their peculiar structure for no purpose except to avoid §1031(f)." The presence of the QI, which ensured that *Teruya* was "technically exchanging properties with the qualified intermediary . . . served no purpose besides rendering simple – but tax disadvantageous –

shifting was not required for a transaction to have a tax avoidance purpose, and that a related-party transaction may have a tax avoidance purpose where there is no basis shifting.[69] Although the related corporation recognized more gain than the taxpayer would have in a sale as opposed to an exchange – because of the use of NOLs, – the taxpayer was able to cash out of the relinquished property with virtually no tax liability. The Tax Court also dismissed as irrelevant the taxpayer's claim that it had initially intended to purchase replacement property from an unrelated party.

v. **Ninth Circuit Affirms Tax Court.** The Ninth Circuit, in a "Not For Publication" Memorandum Opinion, (No. 16-73959; 2019) affirmed the decision of the Tax Court. During oral argument, which was recorded and posted to Youtube, The oral argument took place in Honolulu. In its result-

transactions more complex in order to avoid §1031(f)'s restrictions." The exception found in § 1031(f)(2)(C) was inapplicable since "the improper avoidance of federal income tax was one of the principal purposes behind these exchanges." (No. 05-73779; 9/8/09). The Ninth Circuit upheld the decision in 2010.

69 In a typical basis-shifting transaction, related taxpayers wish to sell low basis property and avoid gain. This is accomplished by exchanging the low-basis property for high basis property. After the exchange, what was the low basis property in the hands of A is now in the hands of the related party B who transferred high basis property in the exchange. B may now sell high basis in the property having minimized gain. When this occurs, cash "leaves" the group of related parties. Proof: Assume that before the exchange, Property A, in the hands of A, had basis of 10 and FMV of 100; and Property B, in the hands of B, had basis of 90 and FMV of 100. After the exchange A now has Property B, whose basis is 90. A sells Property and reports gain of 10, and has $90 in cash. That $90 is said to have "left" the group as result of the transaction.

oriented affirmation of the Tax Court's decision, the Ninth Circuit mostly parroted the analysis of the Tax Court.

vi. **Note on IRS Evolving View of Section 1031(f).** Clearly, a direct exchange of properties between related parties will be respected if the 2-year "holding period" is observed. It is less clear why what occurred in *Teruya* or *Malulani* violated the statute. In Rev. Rul. 2002-83, the IRS articulated its rationale, which was adopted in those cases. The taxpayer may not transfer relinquished property to a QI and acquire replacement property from a related party, since QI will have been inserted to circumvent 1031(f). The Ruling furnishes this example:

(1) Individual A owns Property 1 with a tax basis of \$50,000 and FMV of \$150,000. Individual B owns Property 2 with a tax basis of \$150,000 and FMV of \$150,000. A and B re related parties for the purposes of §1031(f). A transfers Property 1 to C, an unrelated individual, using a qualified intermediary. QI then uses the exchange funds to pay B for Property 2, and A acquires Property 2 as A's replacement property.

vii. **Courts Now Applying *Court Holding* Principle to 1031(f)?** *Malulani*, and several other similarly-decided cases since *Teruya* indicate that Section 1031 is a tax-deferral provision; and that under Section 1031(f), the IRS and the Courts have power to deny deferral in cases not only where basis-shifting has occurred, but also where the taxpayer benefits from other tax provisions and in so doing liquidates potential income tax liability. The rationale for these cases is similar to that of *Com'r v. Court Holding*, 324 U.S. 331 (1945). There, the Tax Court found that the transaction in question – formally a sale by stockholders of property conveyed to them as a "liquidating dividend" – was in essence a sale by the corporation, rather than by the stockholders. The Supreme Court upheld the decision.

f. ***Gerhardt v. Com'r*, 160 T.C. No. 9 (4/20/20223).** Gerhardt sold low-basis property in Iowa consisting of hog buildings and equipment for property in Cape Coral, Florida. The taxpayer reported, and the IRS agreed, that the exchange qualified under Section 1031. However, the property also contained depreciated Section 1245 property, the gain on which the Commissioner asserted should not be deferred, but rather taxed as ordinary income. The taxpayer argued – wrongly – that Section 1031 trumped Section 1245 recapture.

i. **Analysis.** If both section 1245 property and non-section 1245 property are disposed of in the same transaction, then gain is allocated between the section 1245 property and the non-section 1245 property in proportion to their fair market values. Treas. Reg. §1.1245-1(a)(5). Section 1245 states that "Gain from the disposition of section 1245 property shall be recognized notwithstanding any other provision of this subtitle. Since *Gerhardt* had not shown that any of the consideration received was allocable to non-section 1245 property, the entire gain was recognized.[70]

70 Section 1245 property is any depreciable property consisting of either tangible personal property or intangible amortizable personal property described within Section 1245(a)(3)(B) through (F). Section 1245 property employs "accelerated" or "front-end loaded" methods of depreciation, such as 200 percent or 150 percent declining balance. Whether property constitutes Section 1245 property for depreciation purposes is a federal tax determination. If both section 1245 property and non-section 1245 property are disposed of in the

ii. **Minimizing Section 1245 Recapture.** Through a cost segregation study, it may have been possible for *Gerhardt* to allocate some of the purchase price to land, buildings, or another asset that qualified as non-depreciable real property. Had the replacement property in Coral Springs contained any Section 1245 property, the regulations provide that the Section 1245 property received may offset the Section 1245 property relinquished.

iii. **Allocation in Purchase Price.** In situations where the Section 1245 property is being relinquished in an exchange, but the replacement property has little or no Section 1245 property, the seller may negotiate with the buyer and allocate less of the purchase price to Section 1245 property. If the relinquished and replacement properties both contain Section 1245 property, two separate purchase price allocations may be negotiated to benefit both taxpayers. The regulations allow Section 1245 property to be netted first against relinquished Section 1245 property, reducing ordinary income recapture.

17. **Conclusion.**

a. **Determining Real Property.** The final regulations first look to state or local law in defining real property. They then determine whether the asset is an (i) "inherently permanent structure" (e.g., the Empire State Building or other "enclosed" structure with four walls and a roof); (ii) an "other" IPS (e.g., tunnels, non-enclosed

same transaction, then gain is allocated between the section 1245 property and the non-section 1245 property in proportion to their fair market values. Treas. Reg. §1.1245-1(a)(5).

stadiums, or even a "5 ton sculpture" in a building lobby). IPSs and OIPSs must be *permanently affixed* to land or another IPS. "Structural components," (iii), may also qualify if they are "a constituent part of, and integrated into, an [IPS]." "Similar" assets not "listed" in the regulations may qualify under a test. Pre-TCJA real property continues to qualify; ineligible property continues to be ineligible. Section 1031 has no effect on definitions of real property under other Code provisions.

b. **Distinct Assets.** All real property must be a "distinct asset." Each distinct asset must be separately analyzed "separately from any. . .asset to which it relates to determine if [it] is real property, whether as land, an inherently permanent structure, or a structural component of an [IPS]." If interconnected assets "work together to serve an IPS (e.g., systems that provide a building with electricity, heat, or water), the assets are analyzed together as one distinct asset that may qualify as a structural component of real property."

c. **"Incidental Property Rule."** The final regulations create the legal fiction that no "(g)(6)" violation of the deferred exchange escrow rules occurs if "incidental personal property" commonly associated with "commercial transactions" included in the exchange is purchased by the QI with escrow funds. However, incidental personal property may not exceed 15 percent of the value of all replacement properties received in the aggregate. The aggregation of all replacement properties in computing the 15 percent limit provides flexibility. Fifteen percent is neither a safe harbor nor a "bright line;" whether an exchange qualifies depends on "all the facts and circumstances" of a particular transaction.

d. **Elimination of "Purpose or Use" Test; Intangible Property.** Tangible personal property permanently affixed to real property qualifies as real property "irrespective of the purpose or use of the property or whether it contributes to the production of income." However, the "business use" of intangible property will result in its not qualifying as real property. The state and local law test applies to both tangible and intangible property. Intangible property excluded before TCJA, such as partnership interests, regardless of their classification under state or local law, since such property was never eligible for like kind exchange treatment.

e. **"Like Kind" Issues Not Addressed.** The final regulations do not address the "like kind" requirement. How structural components of IPSs will affect the like kind requirement will likely require IRS clarification, since once no longer affixed, dis-integrated from the IPS, neither machinery nor structural components are remain real property, but rather revert to personal property. How structural components of larger assets affect the like kind determination of assets to which they are tethered remains unclear, even if they are considered as one distinct asset.

	Listed IPS & OIPS are Distinct Assets and Real Property	Non-Listed IPS & OIPS are Distinct Assets but must pass real property test	Listed Structural Components are Distinct Assets and Real Property	Non-Listed Structural Components Are Not Distinct Assets. Must First Pass Distinct Asset Test (A) in order to proceed to real property test for SC.	Non-Listed Structural Components Which Have Passed Distinct Asset Test (A), May take Real Property Test (B).	Listed Structural Components are Distinct Assets and Real Property
Result	Real Property	Real Property if IPS or OIPS passes real property test (C)	Real Property	May proceed to real property test (B) if SC passes distinct asset test (A)	Real Property if SC passes real property test (B)	Real Property
(A) Distinct Asset Test For SC of IPS	**Exempt**	**Exempt**	**Exempt**	Not Exempt If SC passes Distinct Asset Test (A), may proceed to (B)	N/A	**Exempt**
Real Property Test for IPS and OIPS (C)	**Exempt**	Not Exempt	**Exempt**	N/A	N/A	**Exempt**
(B) Real Property Test for SC of IPS	N/A	N/A	N/A	Not Exempt	Not Exempt	

Facts and Circumstances Test for Distinct Assets applicable to all items.
Facts and Circumstances Test for Real Property Determination for IPSs and OIPSs
Facts and Circumstances Test for Real Property Determination of Structural Components of IPSs.
C:\Users\dsilv\Dropbox\documents\CPE\2024\Like Kind Exchange Seminar Update December 2024\Facts & Circumstances chart for distinct asset classification 12.31.wpd

APPENDIX B

IRC SECTION 1031 FINAL REGULATIONS
REQUIREMENTS FOR REAL PROPERTY STATUS

All IPS & OIPS (Listed & Non-Listed) ---------) Distinct Asset
Listed SC of IPS---------------------------------------) Distinct Asset
Non-Listed SC of IPS---------(Test1)---------------) Distinct Asset

Listed IPS & OIPS -----------------------------------) Real Property
Non-Listed IPS & OIPS -----(Test2)-----------------) Real Property
Listed SC of IPS ---) Real Property
Non-Listed SC of IPS --------(Test3)-----------------) Real Property

---

Listed IPS & OIPS --------------------------------------) Distinct Asset & Real Property
Non-Listed IPS & OIPS —(Test 2)-----------------) Distinct Asset & Real Property
Listed SC of IPS ---) Distinct Asset & Real Property
Non-Listed SC of IPS -----(Test 1)----(Test 3)-----) Distinct Asset & Real Property

<u>Distinct Asset & Real Property Qualification</u>

<u>Abbreviations</u>:
IPS: Inherently Permanent Structures
OIPS: Other Inherently Permanent Structures
SC of IPS: Structural Components of Inherently Permanent Structures

Test 1: **Distinct Asset Test For Structural Components of Inherently Permanent Structures**

Test 2: **Real Property Test for Inherently Permanent Structures & Other Inherently Permanent Structures**

Test 3 **Real Property Test for Structural Components of Inherently Permanent Structures.**