Final Regs Defining "Real Property" for Section 1031: IRS Gets It Right With "State Law Plus"

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The authors believe that the final Section 1031 regulations provide appropriate and useful guidance to taxpayers on the question of what is "real property," and thus eligible for like-kind exchange treatment under Section 1031, are consistent with the Congressional mandate on post-TCJA Section 1031, and will serve both tax administrators and the public well.

On June 13, 2020, the IRS issued proposed regulations ("Proposed Regulations") addressing the definition of "real property" for purposes of Section 1031. As we wrote in the October 2020 issue of the JOURNAL OF TAXATION[1] (we refer to our prior article as "Regs1"), from 1921 until 2018, Internal Revenue Code Section 1031 permitted like-kind exchanges of both tangible and intangible real and personal property. The Tax Cuts and Jobs Act of 2017 ("TCJA") changed that, limiting application of the deferral regime of Section 1031 to real property for exchanges starting in 2018.[2] We noted two predicates to this change: first, Congress did not eliminate the need to apply the "like-kind" standard when comparing relinquished to replacement real property and, second, Congress expressly indicated that real property previously eligible for like-kind exchange treatment should continue to be eligible.[3]

On November 20, 2020, Final Regulations were released. As discussed below, the definition of "real property" included in the Final Regulations diverges from the approach taken in the Proposed Regulations and hews closer to the administrative and judicial rules existing prior to TCJA. We applaud this revision.

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The need to understand what constitutes real property for Section 1031 purposes gained greater importance following TCJA. The long-standing regulations concerning the application of Section 1031 ("Prior Regs") were silent on what is "real property," dealing only (in somewhat truncated fashion) with determining when something considered real property is like-kind to something else that is real property, coupled with the unstated assumption that real property was not like-kind to personal property.[4] Since adoption, the Prior Regs had provided that the like-kind test (which is applicable when comparing relinquished and replacement real property) involves a comparison of the "nature or character" not the "grade or quality" of exchanged properties.[5] Whether real estate is improved or unimproved has not been and is not material, nor is the character of the property as productive or unproductive, except where held by a dealer, since real property used in a trade or business can be like-kind to real property held for investment and vice-versa.

As we noted in Regs1, there is a significant body of law, in the form of both judicial opinions and Internal Revenue Service ruling determinations, addressing the question of what constitutes like-kind real property. We will not repeat our review of this authority here. Suffice it to say that, on this threshold definitional question, all authority prior to 2012 agreed: taxpayers were directed to look to state law definitions in the state where property was located to determine whether a specific interest was or was not classified as real property. Where taxpayers transferred outright permanent ownership of an asset classified as real property under applicable state law, and acquired outright permanent ownership of an asset classified as real property under applicable state law, all authority prior to 2012 concluded that such assets would be like-kind for Section 1031 purposes. While the Proposed Regulations deviated from this starting point, the Final Regulations endorse it.

We also emphasized in Regs1 that if an asset was treated as real property under state law, then its purpose or use was not a factor in determining whether or not the asset should be treated as real property for purposes of Section 1031. Again, and as discussed in more detail below, while the Proposed Regulations deviated from this starting point, the Final Regulations endorse it.

Both the Proposed and Final Regulations also include a fix for a newly discovered theoretical problem with deferred exchanges where relinquished property sale proceeds will be used to purchase replacement assets that include personal property, such as a hotel with significant moveable furniture and non-real estate equipment. The clarifying rule, also discussed below, protects a taxpayer from completely losing the benefit of Section 1031 due to the constructive receipt principles applicable to like-kind exchange qualified intermediaries under Regs. 1.1031(k)-1(g)(6). However, the limited scope of this new protective rule was initially confusing to some and might lead to unfortunate consequences if misunderstood.[6]

The definition of "real property" included in the Final Regulations diverges from the approach taken in the Proposed Regulations and hews closer to the administrative and judicial rules existing prior to TCJA.

The Construct of Regs 1.1031(a)-3

The Final Regulations contain the same "basic" definition used in the Proposed Regulations, which is that "real property" consists of land and improvements to land, and improvements to land include certain specified types of property as well as structural components of improvements to land. Examples of improvements to land and structural components are provided, as well as certain facts-and-circumstances tests that can be applied when an asset is not specifically described in the Regulations. We will discuss these tests below.

We think four major aspects of the final Regulations should be highlighted:

First, the definition of real property under Regs 1.1031(a)-3 applies an approach we will call "State Law Plus." This is accomplished through a three-part test set forth in the preamble to the Final Regulations:

1. Is an asset treated as real property under state law? If it is, then it is real property for purposes of Section 1031,
2. If not so treated under state law, is the asset specifically described in the Regulations as an improvement to land or a structural component of an improvement to land, and
3. If not specifically described, is the asset treated as an improvement to land or a structural component of an improvement to land under the facts-and-circumstances test?

That is, state law definitions are the starting point, and if property is clearly real property for state or local law purposes, it is real property for Section 1031 purposes.[7] There will also be types of property not characterized as real property under state law, but which will nonetheless be treated as real property for purposes of Section 1031 to the extent specified in the Final Regulations, or which satisfy a facts-and-circumstances test. This framework, which is used to determine the treatment of improvements to land and related structural components,

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[1] *See* Weller, Lipton, Christianson, Carlson "Proposed Regs Define 'Real Property' for Section 1031: IRS Gets It Mostly Right but Insists on Perpetuating Earlier Mistake," 133 JTAX 7 (October 2020).

[2] Section 13303 of P.L. 115-97 (131 Stat. 2054).

[3] *See* H. Rep't 115-466 at 396 n. 726 (2017).

[4] The now moot question of what personal property was like-kind constituted the subject matter of Regs. 1.1031(a)-2.

[5] Regs. 1.1031(a)-1(b).

[6] Regs. 1.1031(k)-1(g)(8)(vi).

[7] Regs. 1031(a)-3(a)(1).

occupies a significant part of the Regulations.

Second, a variety of intangible interests in real property, that may or may not be real property for state law purposes, are included in the definition.

Third, the Regulations' definition of real property is expressly limited to Section 1031. It creates no inference of application to the tax credit,[8] cost recovery, cost capitalization,[9] real estate investment trust,[10] foreign investment withholding,[11] or any other regime that looks to distinctions between real and personal property.

Finally, the new Regulations are clearly limited to defining real property that comes within the ambit of Section 1031 and do not address the separate question of determining whether relinquished and replacement real property are like-kind.

"State Law Plus"

In a somewhat obscure Chief Counsel Advice issued in 2012,[12] the Internal Revenue Service decided that two identical assets located in different states (inground oil and gas pipelines) must be like-kind under Section 1031, even though one state classified the asset as real property and the other state classified the asset as personal property. To reach that result, the Chief Counsel asserted that federal law essentially preempted state law. However, the CCA didn't stop there. In reviewing another set of examples dealing with assets that were conceded to be real property for applicable state law purposes, it applied an additional test looking at the function served by the assets, not the duration or character of a taxpayer's ownership, to determine whether they were like-kind.

This novel approach attracted some criticism when it was made public,[13] but had not really been put under a microscope by the tax community because many thought it had limited application. Unfortunately, as we will discuss below, in undertaking the project to write post-TCJA regulations, the IRS decided it was appropriate to look to that CCA as a touchstone. This provoked a significant amount of commentary from the public (including the present authors, in Regs1) that ultimately led Treasury and the IRS to rethink the approach and return (with some salutary clarifications) to alignment with prior law—with a "Plus." By Plus, we refer to several new lists of assets included in the Final Regulations which are automatically regarded as real property despite uncertain or contrary characterization under state law. The lists further include a new category of "Intangible Interests," as well as methodologies to reach real property classification for assets not on the lists.

Applicable "state law" for purposes of the Regulations is both state and local law applicable to the location of the property in question.[14] While not explicitly explained, we assume the reference to local law is included to cover circumstances where law of a county or local jurisdiction applies to an asset, but the law of the state where the asset is located is silent on its classification.

The Final Regulations presume, however, that a state's law will not always be clear on whether an "improvement" is classified as real property, and that there will be situations where state law will differ for the same asset (as with oil pipelines in the 2012 CCA). The Final Regulations address this in two ways: by specifically listing items to be classified as real property regardless of state law classification, and by creating analytic tests to be applied to assets that are not included in the specific lists. In both cases this is additive to state law classification.

With respect to identical assets classified differently by different state law regimes, the Final Regulations reject the CCA conclusion that identical assets must qualify as like-kind regardless of state law because they have the same nature or character, but solve the problem through the "Plus" approach of listing assets and creating rules that will overlay a federal classification system that overcomes state law differences. The solution is found in the list of "inherently permanent structures" which are defined as real property regardless of their state or local law classification.

The Final Regulations start with the proposition that buildings and "other inherently permanent structures" (referred to below as "OIPS") are real property. The term "building" is broadly defined to include "any structure or edifice enclosing a space within its walls and covered by a roof," going on to provide "[b]uildings include the following distinct assets if permanently affixed: houses, apartments, hotels, motels, enclosed stadiums and arenas, enclosed shopping malls, factories and office buildings, warehouses, barns, enclosed garages, enclosed transportation stations and terminals, and stores." Gone in the Final Regulations is any reference to the specific purpose served by a building as relevant to its classification as real property.[15]

In order to deal with state law uncertainty and potential inconsistency,

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[8] Section 48.

[9] Regs. 1.263(a)-3(b) and 1.263A-8(c).

[10] Reg. 1.856-10.

[11] Reg. 1.897-1(b).

[12] CCA 201238027.

[13] *See* Weller, "IRS Muddies the Like-Kind Waters in Guidance Considering State Law Classification," 118 JTAX 13 (January 2013).

[14] Regs. 1.1031(a)-3(a)(6).

[15] *Compare* Prop. Regs. 1.1031(a)-3(a)(2)(ii)(B) with final Regs. 1.1031(a)-3(a)(2)(ii)(B).

[16] Dropped from this list between the Proposed and Final Regulations were "enclosed transportation stations and terminals," presumably because this is the topic of analysis in Example 4, discussed below.

[17] Reg. 1.1031(a)-3(b)(3).

[18] Reg. 1.856-10(d)(2)(iii)(A).

[19] Regs. 1.1031(a)-3(a)(2)(iii).

[20] Regs. 1.1031(a)-3(a)(2)(iii)(A).

[21] Regs. 1.1031(a)-3(a)(2)(iii)(B) provides that "[s]tructural components include the following items, 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."

[22] The American Society of Cost Segregation Professionals ("ASCSP") has defined cost segregation as "the process of identifying personal property assets that are grouped with real property assets and separating out personal assets for cost recovery reporting purposes." *See* ASCSP Comments for Proposed Regulations 1.1031(a)-3 (8/6/2020), available at https://ascsp.org/wp-content/uploads/2020/08/ASCSP-Comments-for-Proposed-Regulations-1.1031a-3-REG-117589-18-1-1-1.pdf.

[23] Prop. Regs. 1.1031(a)-3(b)(5).

[24] Prop. Regs. 1.1031(a)-3(b)(6).

the OIPS definition goes on to describe numerous kinds of man-made additions to land that are included in the definition of real property if they are "inherently permanent" or "permanently installed." Specifically listed additions which meet these requirements are: "in-ground swimming pools; roads; bridges; tunnels; paved parking areas, parking facilities, and other pavements; special foundations; stationary wharves and docks; fences; inherently permanent advertising displays for which an election under section 1033(g)(3) is in effect; 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 drilling platforms, derricks, oil and gas storage tanks; and grain storage bins and silos."[16] An improvement may be regarded as permanently installed or affixed by reason of weight alone.

Of particular note is the attention paid by Treasury and IRS, both in the Regulations and in the Supplementary Information released with them, to petroleum industry assets, including offshore platforms and pipelines. In general, these assets receive real property classification as inherently permanent structures.

Where a specific type of OIPS is not listed but might arguably fit within the general criteria for OIPS, the Regulations (both Proposed and Final) provide a five-factor test to establish qualification. Reg 1.1031(a)-3(a)(2)(C) lists the following factors:

- the manner in which the distinct asset is affixed to real property,
- whether the distinct asset is designed to be removed or to remain in place,
- the damage that removal of the distinct asset would cause to the item itself or to the real property to which it is affixed,
- any circumstances that suggest the expected period of affixation is not indefinite, and
- the time and expense required to move the distinct asset.

While at present we do not know whether all factors must be present or, if not, what weighting they are to receive, the test is essentially a surrogate for the common-law definition of a "fixture." It has the salutary effect in Example 3 of the Final Regulations of making a large indoor sculpture placed in the atrium of a building a real property asset[17] and it appears that the classification would apply even if the sculpture was not situated inside a building, since the five-factor test does not make this a requirement.

The most controversial aspect of the Proposed Regulations was their exclusion as real property for Section 1031 purposes of assets classified as machinery and building systems that serve machinery . . . , [t]his approach received almost universal rejection from commenters and was, on review, determined by Treasury and IRS to be inappropriate.

The Final Regulations consciously reject any functional test for OIPS of the sort that appears in REIT regulations, treating as real property assets eligible for REIT ownership OIPS that serve a "passive function" and "do not serve an active function."[18]

Besides land and inherently permanent structures, the Regulations establish a third category of property that can be viewed as real property but must be analyzed separately: structural components of an inherently permanent structure.[19] It appears to us that this category flows directly from the current practice of identifying separate components of a building in a cost segregation study. In defining structural components, the Regulations focus on whether an item is "a constituent part of and integrated into an inherently permanent structure."[20] A laundry list of examples is provided [21] that includes most items typically identified as separate assets in a cost segregation study,[22] as well as a four-part test applicable where an alleged structural component is not listed. This four-part test provides that the following factors are relevant:

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

Regs Abandon the Machinery Exclusion

The most controversial aspect of the Proposed Regulations was their exclusion as real property for Section 1031 purposes of assets classified as machinery and building systems that serve machinery, even where such assets were clearly real property under state law and would have qualified as such for Section 1031 purposes under prior law. This approach received almost universal rejection from commenters and was, on review, determined by Treasury and IRS to be inappropriate.

The IRS's change of position is illustrated by changes in classification of assets described in several of the Examples. Example 5 of the Proposed Regulations characterized a 12-ton machine installed during a building's construction and designed to remain in place indefinitely as personal property because it produced products to be sold and used away from the building where it was located.[23] Similarly, a back-up generator installed at the same time that served both the machine and the building was real property, but where the generator served only the machine, it was personal property.[24]

These Examples are revised in the Final Regulations to make clear that the real property classification applies to both the 12-ton machine and its back-up generator, irrespective of function.[25]

A steam turbine installed during construction of the building and designed to remain in place indefinitely that produces electricity for sale to customers by an electric utility (of course the subject of the CCA) exhibits the same change in classification from the Proposed (not like-kind to real property) to Final Regulations (classified as real property).[26]

But not everything associated with buildings or building-like assets is real property. In two examples the Final Regulations disclaim real property classification for improvements that are essentially removable and portable. Example 4 deals with modular prefabricated bus shelters that are not permanently affixed to land and will not take significant time or expense to move,[27] and Example 6 deals with raised flooring for a machine that, again, is designed to be installed and removed easily and with little expense.[28] In these cases, state-law fixture treatment would probably not apply and the Regulations' application of the five-factor test rejects real property classification. However, neither of these examples resuscitates the "function" test abandoned by the Final Regulations.

Distinct Assets

Another construct included in the Regulations is the notion that "a distinct asset is analyzed separately from any other assets to which the asset relates to determine whether the asset is real property, whether as land, an inherently permanent structure or a structural component of an inherently permanent structure."[29] Buildings are separate from OIPSs. Structural components that are separately listed in the laundry list of such components found in Regs. 1.1031(a)-3(a)(2)(iii)(B) are separate assets. Another four-part test applies to determine when a separately identifiable item not specifically mentioned in the list must be classified:

- whether the item is customarily sold or acquired as a single unit rather than as a component part of a larger asset,
- whether the item can be separated from a larger asset, and if so, the cost of separating the item from the larger asset,
- whether the item is commonly viewed as serving a useful function independent of a larger asset of which it is a part, and
- whether separating the item from a larger asset of which it is a part impairs the functionality of the larger asset.[30]

In light of the change to a "State Law Plus" definition of real property, it remains to be seen how often these tests will matter.

Products of or from Land

Consistent with prior law, unsevered natural products of land, such as growing crops, plants, and timber, are expressly characterized as real property under the Final Regulations. Once severed, extracted, or removed from the land, natural products cease to be real property.[31]

Intangibles and Their Potential Opportunities

The Final Regulations follow the Proposed Regulations in directly addressing a topic that has been somewhat controversial over the years and may continue to give rise to dispute: treatment of various "less than fee" interests that relate to real property. This topic is now elevated to its own subsection of the Regulations: -3(a)(5). The specific list includes "a leasehold, an option to acquire real property, an easement, stock in a cooperative housing corporation, shares in a mutual ditch, reservoir or irrigation company[32] and land development rights."

More generally, an intangible that derives its value from a real property interest and is inseparable from that interest is real property.[33] This includes licenses, permits, or similar rights "in the nature of a leasehold or easement" but not licenses or permits to engage in a business on real property if they contribute to production of income other than as consideration for use and occupancy of the real estate.[34]

Interests in real property can vary from outright fee ownership. Listing several types of ownership interests that qualify as real property, the Regulations highlight opportunities for tax deferral under Section 1031 when these assets are sold or bought. Significantly, the Final Regulations are silent on the key question of how to apply the like-kind standard to these assets. Of great interest to taxpayers is the specific inclusion of options to acquire real property, which by their nature do not involve present possessory interests (unless coupled with a lease or license), as real property for Section 1031 purposes. Under current law, there were differences of opinion as to whether gain recognized on the sale of a real property option or contract rights could qualify for deferral under Section 1031 when the seller never took title to the underlying property;

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[25] Regs. 1.1031(a)-3(b)(5).

[26] *Compare* Prop. Regs. 1.1031(a)-3(b)(8) with Regs. 1.1031(a)-3(b)(7).

[27] Regs. 1.1031(a)-3(b)(4).

[28] Regs. 1.1031(a)-3(b)(6).

[29] Regs. 1.1031(a)-3(a)(4(i).

[30] Prop. Regs. 1.1031(a)-3(a)(4)(ii).

[31] Regs. 1.1031(a)-3(a)(3).

[32] The Proposed Regulations and the Final Regulations faithfully follow the direction of Congress not to take away real property classification from mutual ditch, reservoir, or irrigation company stock for entities described in Section 501(c)(12)(A) where "the shares have been recognized by the highest court of the State in which the company was organized or by a State statue as constituting or representing real property or an interest in real property."

[33] Regs. 1.1031(a)-3(a)(5).

[34] Prop. Regs. 1.1031(a)-3(a)(5)(ii).

[35] For discussion of this issue, see Field Service Advice 1995-12 (5/30/1995) which discusses whether an option is like-kind to a fee interest in other real estate. The FSA cites Koch, 71 TC 54 (1978), which examined whether the exchanger's money was "still tied up in real property of the same class or character as they owned before the exchange." 71 TC at 66. The exchange described in that FSA was disallowed on other grounds.

[36] Prop. Regs. 1.1031(a)-3(b)(11).

[37] Prop. Regs. 1.1031(a)-3(b)(12).

[38] Regs. 1.1031(a)-3(a)(5)(i).

[39] Regs. 1.1031(a)-3(a)(6).

[40] *Id.*

[41] Where the personal property associated with replacement real property does not exceed 15% of the total value of the combined real and personal property, no separate identification of the personal property is necessary. Regs. 1.1031(k)-1(c)(5).

[42] Reg. 1.1031(k)-1(g)(7)(iii).

some practitioners believed it did, others did not.[35]

The Final Regulations resolve this question favorably, but they do not answer the question whether an option to acquire real estate will be like-kind only to another option or option-equivalent or other real property interests. Will the term of an option be equated to the term of a lease for this test—creating a more than 30-year and less than 30-year distinction, as with leases? If no durational test applies, the ability to exchange "in the money" options for other real estate could be of great benefit to taxpayers. If the like-kind test requires that options or other interests have equivalent terms, i.e., an option with a 5-year term is like-kind only to an option or lease with a 5-year term, then this clarification may be of limited practical importance.

The rules relating to permits, licenses, and land development rights seem reasonable and should generally be easy to apply. A permit to use public land for placement of a cell tower is like a lease, even if state law provides that such permits are not leases but merely grant use rights that are terminable by the government if needed for "a higher public use."[36] But, under the Final Regulations, a license to operate a casino in a specific building that cannot be transferred to another building is not real property.[37] Assuming the license is transferable to a buyer of the building, it presumably has significant value, likely exceeding its adjusted cost basis. In the past, where the building was sold with the license, gain associated with the license could have been deferred if the seller acquired another licensed casino building. Post-TCJA, there will be no ability to defer gain on value allocated to the casino license on a sale—encouraging sellers to artificially depress the value of the license rights. Of course, this may be countered by saying that buyers will still want to assign value to such licenses in order to amortize their costs under Section 197 over 15 years rather than be subject to 39-year cost recovery under Section 168.

The Final Regulations also clarify that the repeal by the TCJA of former Sections 1031(a)(2)(B) through (F), which contained a list of property excluded from Section 1031 treatment, did not make any of these categories eligible for Section 1031, even if such assets could be viewed as real property under state law. The Final Regulations contain an express exclusion for each of the former categories in the definition of potentially qualifying intangible assets "regardless of the classification of such property under State or local law."[38] This puts to bed the assertion made by some in light of TCJA's repeal of former Section 1031(a)(2)(D) that real estate partnership interests held in tenant-in-common form might again be qualified for Section 1031.

The IRS clearly explains in its introduction to the Final Regulations that this rule does nothing to eliminate boot treatment for receipt of any personal property in a Section 1031 exchange, regardless of how "incidental."

No Inference Provision

Of great relief to the cost segregation industry and others is the continuation of the rule contained in the Proposed Regulations that limits application of the classification rules to the characterization of property under Section 1031, and affirms that a classification under those rules has no application under other provisions of the Code, including accelerated depreciation under Section 168, recapture under Sections 1245 and 1250, for REIT purposes under Section 856, or for withholding purposes on sales of real property owned by nonresident taxpayers under Section 897.[39] While cost segregation of relinquished or replacement property will have no effect on qualification under Section 1031, the Regulations remind us that the recapture consequences of an exchange out of or into real property that has been the subject of a cost segregation study should not be ignored.[40]

Incidental Property Clarification

The Final Regulations preserve the aspect of the Proposed Regulations that addressed and gained some notoriety when the restriction of Section 1031 to real property went into effect in 2018. Under Prior Reg. 1.1031(k)-1(g)(6)(i), a qualified intermediary could not use exchange funds for the purchase of non-qualified property during the exchange period without jeopardizing the deferral for the taxpayer's exchange. With limited exceptions, exchange funds could only be used to purchase like-kind property. Following the enactment of TCJA, practitioners recognized that exchange proceeds generated by a sale of real property could no longer be used to purchase replacement property that included any personal property, such as a hotel acquired along with its furniture and service equipment.

The "incidental property" rule included in the Proposed and Final Regulations addresses this in a favorable way by providing the same 15% test applicable to replacement property identification in a deferred exchange.[41] That rule will now also apply to use of relinquished property proceeds to buy replacement property consisting of both real and personal property. This is accomplished by adding an incidental personal property exception to those items to which funds held by a qualified intermediary can be applied. This consists of personal property incidental to real property that does not exceed 15% of the aggregate value of the replacement real property.[42] This applies only where the personal property is typically transferred along with the real property in standard commercial transactions.

Despite some mistaken commentary that followed issuance of the Proposed Regulations, and the request of some commenters to make it so, the IRS clearly explains in its introduction to the Final Regulations that this rule does nothing

to eliminate boot treatment for receipt of any personal property in a Section 1031 exchange, regardless of how "incidental." To avoid boot in these cases, if possible, purchase consideration should be allocated among the real property assets and any tangible property transferred with it, and non-exchange funds should be advanced to acquire any nonqualified property in a deferred exchange.

An example illustrates both the continued boot treatment of the personal property receipt and the constructive receipt safe harbor: where relinquished property worth $1,100,000 having basis of $400,000 is transferred (resulting in $700,000 realized gain) and replacement real property worth $1,000,000 plus $100,000 in associated personal property is identified and acquired, the taxpayer recognizes $100,000 of the total realized gain due to the non-like-kind personal property receipt, but is not deemed to be in constructive receipt of the $1,100,000 placed with the QI and, thus, defers $600,000 of the realized gain.[43]

Correcting a 38-Year-Old Mistake

When Reg. 1.1031(k)-1 was promulgated in 1992, it contained a clear numerical error that annoyed careful readers for the ensuing 38 years. Examples 3 and 4 in Regs. 1.1031(k)-1(d)(2) both use a property value of $250,000 for land which consists of two components—a barn and underlying land and additional land—but state that the barn is worth $187,500 and the adjacent land is worth $87,500, totaling more than the stared composite value. This error was finally corrected to reduce the $87,500 figure to the correct $62,500. A long time coming, but at least no longer a conundrum.

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[43] Reg. 1.1031(k)-1(g)(8)(vi).

Unfinished Business

There are several pieces of unfinished business that the Final Regulations expressly decline to address or simply ignore that should be the subject of future guidance. In no particular order of importance:

- The consequences of allocation of debt to personal property in multiple asset exchanges pursuant to Reg 1.1031(j)-1 that now seems to compel boot treatment where mixed real and personal property subject to debt is transferred because the debt automatically allocated to the personal property cannot be offset by acquisition of like-kind personal property.
- While they are not consequences of the TCJA modification to Section 1031, the following topics invite corrective or further guidance:
  - Regulations under Section 1031(f) should be issued, particularly to clarify the scope of Section 1031(f)(2)(C) and make clear that prior approval of the Secretary is not necessary for application of the "non-tax avoidance" exception incorporated in this provision and to define parameters associated with the anti-abuse principle codified in Section 1031(f)(3).
  - Regulations should be issued clarifying boot-offset treatment in multi-party and deferred exchanges, particularly involving new cash paid by a taxpayer or new debt financing obtained by the taxpayer to acquire replacement property cash or debt relief received by the taxpayer on disposition of relinquished property.

Conclusion

The Final Regulations are a good example of the importance of the notice and comment process at work. There were a number of flaws in the Proposed Regulations, and the Treasury and IRS addressed the most important ones through revisions suggested by the commenters. As finalized, we believe that Regs. 1.1031(a)-3 provide appropriate and useful guidance to taxpayers on the question of what is "real property," and thus eligible for like-kind exchange treatment under Section 1031, are consistent with the Congressional mandate on post-TCJA Section 1031, and will serve both tax administrators and the public well.