On June 11, 2020, the U.S. Treasury Department released highly anticipated proposed Treasury Regulations on like-kind exchanges under Section 1031 (the “Proposed Regulations”). The Proposed Regulations provide much-needed guidance on the topic of like-kind exchanges following the statutory changes to Section 1031 under the Tax Cuts and Jobs Act of 2017 ("TCJA").

Prior to the enactment of the TCJA, property other than “real property” was also eligible for like-kind exchange treatment. The TCJA limited the application of like-kind exchange treatment to only exchanges of real property (generally effective for transactions completed after December 31, 2017, subject to a transition rule).

**Defining Real Property**

Before the TCJA was enacted, neither the Code nor the Treasury Regulations provided a definition of the term “real property” for purposes of Section 1031. The
Proposed Regulations introduces such definition by borrowing language from various other federal income tax rules defining “real property.” However, the Proposed Regulations clarify that the definition is unique to the policies of Section 1031 and expressly state that no inference is intended regarding the status of property as “real property” for other purposes of the Code. Consistent with provisions elsewhere in the Code, the Proposed Regulations state that state and local law definitions generally are not controlling in determining the meaning of the term “real property” for purposes of Section 1031.

Under the Proposed Regulations, real property under Section 1031 generally includes (i) land, (ii) improvements to land, which include inherently permanent structures and the structural components of inherently permanent structures, (iii) unsevered natural products of land, including growing crops, plants, timber, mines, wells, and other natural deposits, and (iv) water and air space superjacent to land.

The Proposed Regulations provide that each distinct asset must be analyzed separately from any other asset 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. Items that are specifically listed in the Proposed Regulations as buildings and other inherently permanent structures are distinct assets. Assets and systems specifically listed in the Proposed Regulations as structural components also are treated as distinct assets. Other distinct assets are identified by using factors provided in the Proposed Regulations.

The Proposed Regulations address the application of these rules to assets that are interconnected and work together to serve an inherently permanent structure such as systems that provide a building with electricity, heat, or water. The Proposed Regulations provide that such assets must be analyzed together as one distinct asset that may qualify as a structural component (and thus represent real property). The Proposed Regulations give the example of a gas line that provides fuel to a building’s heating system and, therefore, comprises a part of the structural component of the heating system, thereby qualifying as real property for Section 1031 purposes. However, if the purpose of a gas line is to provide fuel to the business equipment in a building, such as fryers and ovens in building utilized as a restaurant, the gas line is not a constituent part of an inherently permanent structure and therefore not real property for Section 1031 purposes.

The Proposed Regulations provide that a license, permit, or other similar right that is solely for the use, enjoyment, or occupation of land or an inherently permanent structure and that is in the nature of a leasehold or easement generally is an interest in real property. On the other hand, a license or permit to engage in or operate a business on real property is not real property for purposes of Section 1031 if the license or permit produces or contributes to the production of income other than consideration for the use and occupancy of space (such as gambling licenses and liquor licenses).

**Incidental Personal Property**

The Proposed Regulations address the topic of incidental personal property, in
response to a concern that a constructive receipt of all of the exchange funds held by a qualified intermediary could apply if the taxpayer is able to direct the qualified intermediary to use those funds to acquire property that is not of a like kind to the taxpayer’s relinquished property (which would result in a sale treatment rather than a Section 1031 like-kind exchange).

The Proposed Regulations provide that personal property that is incidental to replacement real property is disregarded in determining whether a taxpayer has rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by a qualified intermediary. 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 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. This incidental personal property rule in the Proposed Regulations is based on the existing rule in the current regulations under Section 1031, which provides that certain incidental property is ignored in determining whether a taxpayer has properly identified replacement property.

**Effective Date**

The Proposed Regulations will apply to exchanges beginning on or after the date the Proposed Regulations are published as final Treasury Regulations in the Federal Register. The preamble to the Proposed Regulations indicates that, pending issuance of the final Treasury Regulations, a taxpayer may rely on the Proposed Regulations, if followed consistently and in their entirety, for exchanges of real property beginning after December 31, 2017, and before the final Treasury Regulations are published.

**Endnotes**

1 All Section references are to the Internal Revenue Code of 1986, as amended (the “Code”).

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