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Familiar Things Made New: Proposed Regulations Define “Real Property” for Like-Kind Exchanges

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Favorable like-kind exchange treatment is now limited to certain exchanges of real property, so taxpayers that intend to defer gain should focus on what new proposed regulations say about real property.

The Tax Cuts and Jobs Act (the “TCJA”), enacted in December 2017, made a significant change in a taxpayer’s ability to defer gain under the like-kind exchange rules of section¹ 1031. In particular, the TJCA narrowed section 1031 so that it applies only to an exchange of *real property* that is (1) held for productive use in a trade or business or for investment, and (2) not held primarily for sale.² As a result, for property exchanges occurring after December 31, 2017,³ gain (or loss) realized on the sale of personal property (both tangible and intangible), including personal property associated with real property, generally is no longer eligible for deferral under section 1031.⁴ There is no exception for

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¹ Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the “Code”) or the applicable regulations promulgated pursuant to the Code (the “regulations”).

² Section 1031(a).

³ The changes to section 1031 generally do not apply to exchanges for which one “leg” was completed prior to January 1, 2018. See Pub. L. No. 115-97, § 13302(c)(2).

⁴ The adverse impact of this change in section 1031 may be tempered by the increased availability of “bonus” depreciation for certain tangible personal property. See section 168(k).

de minimis or “incidental” personal property associated with real property, such as furniture and fixtures common to hotel properties.⁵

Because section 1031 is now limited to real property, the definition of what property constitutes real property for purposes of section 1031 has taken on increased importance. On June 12, 2020, Treasury and the IRS issued proposed regulations that define, for the first time, the term “real property” for purposes of section 1031 (the “Proposed Regulations”).⁶ This article (1) provides an overview of the proposed definition of “real property”; (2) summarizes the framework set forth by the Proposed Regulations for determining whether any particular item of property should be considered real property for purposes of section 1031; and (3) discusses some of the technical ambiguities generated--or at least not fully addressed-- by the Proposed Regulations.⁷

Background

Historically, the IRS and courts looked to the local law classification of property rights when determining whether property should be considered real or personal property for purposes of section 1031 because local law creates the taxpayer’s legal interests and rights in property.⁸ The relevance of this, of course, was that only real property could be like kind to other real property. For example, in Revenue Ruling 55-

⁵ The proposed regulations under section 1031 described in this article also propose a new safe harbor under section 1031 regarding incidental personal property acquired as part of a like-kind exchange. The proposed safe harbor relates to a taxpayer’s qualification for the qualified intermediary, qualified escrow and trust, and interest and growth factor safe harbors in section 1.1031(k)-1(g)(3)-(5). The proposed safe harbor disregards certain incidental personal property in determining whether the taxpayer has actual or constructive receipt of the sale proceeds from the relinquished property. Proposed section 1.1031(k)-1(g)(7)(iii). The proposed safe harbor, however, does not disregard personal property, even if incidental to real property, in determining the gain recognized by the taxpayer under section 1001 (for incidental personal property included in the relinquished property) or section 1031 (b) (for incidental personal property included in the replacement property). For a more detailed discussion of the proposed safe harbor, see Holly Belanger and Debbie Fields, *A Wolf in Sheep’s Clothing: The Proposed New Like-Kind Exchange Safe Harbor, What’s News in Tax*, (Sept. 14, 2020).

⁶ Proposed section 1.1031(a)-3, 85 Fed. Reg. 35835 (June 12, 2020).

⁷ The Proposed Regulations are proposed to apply to exchanges beginning on or after the date the regulations are published as final regulations. Proposed section 1.1031(a)-3(c). Pending issuance of the final regulations, however, 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 regulations are published. See preamble to the Proposed Regulations.

⁸ See, e.g., *Commissioner v. Crichton*, 122 F.2d 181 (5th Cir. 1941) (mineral rights were real property under Louisiana law); *Peabody Natural Resources Co. v. Commissioner*, 126 T.C. 261 (2006) (coal supply contracts were real property under New Mexico law); *Coupe v. Commissioner*, 52 T.C. 394 (1969) (stating that although federal law determines the tax consequences of a taxpayer’s interest in property, the nature of that interest is determined by state law); *Oregon Lumber Co. v. Commissioner*, 20 T.C. 192 (1953) (timber cutting rights were personal property under Oregon law); CCA 201238027 (Sept. 21, 2012), 2012 WL 4261130 (citing *Morgan v. Commissioner*, 309 U.S. 424 (1940), as amended on denial of rehearing, *Aquilino v. United States*, 363 U.S. 509 (1960)); IRS NSAR 20044101F (Oct. 8, 2004), 2004 WL 2368653 (natural gas pipeline was personal property under the relevant state law). Under section 6110(k)(3), the IRS’s written determinations (such as private letter rulings, nondocketed service advice reviews, and chief counsel advice) may not be used or cited as precedent. They are cited here as indications of the IRS’s position on a particular issue.

749,⁹ the IRS concluded that where, under applicable state law, water rights are considered real property rights, the exchange of perpetual water rights for a fee interest in land constituted a non-taxable exchange of like-kind property under section 1031(a).

More recently, however, the IRS concluded that the local law classification of property alone may not be determinative of whether property should be considered like-kind real or personal property for purposes of section 1031. Chief Counsel Advisory 201238027 (the “2012 CCA”)¹⁰ involved an interstate natural gas pipeline and a steam turbine that was attached as a fixture in a building and was a component of a system for the commercial production of electricity. The local law classification of each of these properties varied among the relevant states. In some states, the properties were considered personal property and in other states, they were considered real property. The IRS reasoned that relying *solely* on state property classifications for purposes of a like-kind determination could lead to absurd results and would make U.S. federal tax law dependent on state laws and state policies.

Instead, the IRS explained that all the facts and circumstances, including U.S. federal tax law characterizations of an asset (e.g., under sections 48 and 263A), should be considered in determining whether property is real or personal for purposes of section 1031. In particular, the IRS indicated that buildings, other inherently permanent structures, and certain structural components of an inherently permanent structure should be included in the term “real property” for purposes of section 1031 if those items of property are affixed to real property and would ordinarily remain affixed for an indefinite period of time.¹¹ Applying this approach, the IRS concluded in the 2012 CCA that, regardless of state law classification, natural gas pipelines should be treated as real property for purposes of section 1031 because they were inherently permanent structures that were affixed to real property, would ordinarily remain for an indefinite period of time, and generally transfer along with the land to which they were affixed. The steam turbines, on the other hand, were part of the machinery used in the commercial production of electricity and were not structural components of the land or building. Thus, the IRS concluded that, regardless of state law classification, the steam turbines in question were personal property for purposes of section 1031 (and therefore were not like kind to real property).

The Proposed Regulations

Following the TCJA raising the stakes for what is “real property” in the context of a like-kind exchange, the IRS determined that regulations defining real property for purposes of section 1031 were necessary because taxpayers need certainty regarding whether any part of the replacement property received in

⁹ 1955-2 C.B. 295. See also PLR 200631012 (Aug. 4, 2006) (concluding that whether stock in a cooperative apartment located in New York constitutes real or personal property under section 1031 is determined under New York law).

¹⁰ CCA 201238027 (Sept. 21, 2012), 2012 WL 4261130. Written determinations such as CCAs represent the IRS’s analysis of the law as applied to a taxpayer’s specific facts, and these type of written determinations are not intended to be relied on by third parties and may not be cited as precedent. Section 6110(k). They do, however, provide an indication of the IRS’s position on the issues addressed.

¹¹ Section 1.48-1(c); section 1.263A-8(c)(4)(i). See also section 1245(a)(3). After issuance of the 2012 CCA, the IRS finalized section 1.856-10 which defines the term “real property” for real estate investment trust qualification purposes. The Proposed Regulations borrow heavily from the concepts included in section 1.856-10.

an exchange is non-like-kind property and, therefore, taxable boot under section 1031(b).¹² The Proposed Regulations move away from the overall facts-and-circumstances approach described in the 2012 CCA, instead prescribing a framework to determine the extent to which an item of property is considered real property for purposes of section 1031. Under this framework, except in the case of a mutual ditch, reservoir, or irrigation company (described below), local law definitions are not controlling for purposes of defining the term “real property” under section 1031.¹³ Similarly, unlike the 2012 CCA, which looked to other areas of U.S. federal tax law for guidance on the proper characterization of an asset, the Proposed Regulations do not adopt wholesale an existing definition of real property from another area of the U.S. federal tax law. In the preamble, Treasury and the IRS provided that it would be inappropriate to adopt for purposes of section 1031 an existing definition of real property from another section of the Code or regulations due to the varying purposes of each Code provision and the intent of Congress that real property eligible for like-kind exchange treatment under pre-TCJA law should continue to be eligible for like-kind exchange treatment in years beginning after 2017.¹⁴ Rather, despite their similarity to, and borrowing from, other regulations, the Proposed Regulations are explicit: They apply solely for purposes of the like-kind exchange rules in section 1031 and no inference is intended with respect to the classification or characterization of property for other purposes of the Code.¹⁵

Overview and General Framework

The Proposed Regulations define the term “real property” for purposes of section 1031 to include:

- Land
- Improvements to land (i.e., inherently permanent structures and their structural components)
- Unsevered natural products of land
- Water and air space superjacent to land
- Certain interests in real property (“real property intangibles”)

¹² See preamble to the Proposed Regulations.

¹³ Proposed section 1.1031(a)-3(a)(1).

¹⁴ Preamble to the Proposed Regulations. See H.R. Rep. No. 115-466, at 396, fn. 726 (2017). As an example, the preamble provides that the regulations in section 1.856-10 for real estate investment trusts provide that property having an active function such as producing, manufacturing, or creating a product cannot be real property. Nothing in pre-TCJA section 1031 law suggests that real property held for production use in a trade or business or for investment should necessarily be excluded from the definition of real property under section 1031 because of an active rather than passive function. Thus, using the section 1.856-10 definition of real property for purposes of section 1031 would not be appropriate. Nevertheless, as discussed later in this article, the Proposed Regulations do include a requirement for some property that is focused on the function of the property.

¹⁵ Proposed section 1.1031(a)-3(a)(6).

Under the general framework described in the Proposed Regulations, whether a particular item of property is considered “real property” for purposes of section 1031 is determined as follows:

1. Distinct Assets: The taxpayer must identify each “distinct asset” that is involved in the exchange.¹⁶
 - The Proposed Regulations include lists of structures that qualify as inherently permanent structures or structural components (“Listed Assets”).¹⁷ Listed Assets are generally considered distinct assets for purposes of the Proposed Regulations.¹⁸
2. Land Assets: The taxpayer must identify the distinct assets that are land, unsevered natural products of land, and water and air space superjacent to land. As described below, these items of property are generally treated as real property for purposes of section 1031.
3. Improvements to Land: For every distinct asset that is considered an improvement to land (i.e., buildings, other inherently permanent structures, and structural components of inherently permanent structures), the taxpayer must determine whether the asset is a Listed Asset.
 - If the improvement to land is a Listed Asset, the asset generally is a distinct asset and is real property if the asset is permanently affixed to real property or is a constituent part of, and integrated into, an inherently permanent structure.¹⁹
 - If the improvement to land is not a Listed Asset, the taxpayer must determine, based on factors described in the Proposed Regulations, whether the asset is an other inherently permanent structure or a structural component of an inherently permanent structure.²⁰
4. Interests in Real Property: For every distinct asset that may be an interest in real property, the taxpayer must determine whether the asset should be considered real property based on criteria provided in the Proposed Regulations.²¹ Interests in real property include fee ownership, co-ownership arrangements, leaseholds, options to acquire real property, easements, or other similar interests.²²

Each of these determinations is described in more detail below.

¹⁶ Proposed section 1.1031(a)-3(a)(4).

¹⁷ Proposed section 1.1031(a)-3(a)(2)(ii) (related to buildings and other inherently permanent structures) and (iii) (related to structural components of an inherently permanent structure).

¹⁸ Proposed section 1.1031(a)-3(a)(4).

¹⁹ Proposed section 1.1031(a)-3(a)(2).

²⁰ *Id.*

²¹ Proposed section 1.1031(a)-3(a)(5).

²² Proposed section 1.1031(a)-3(a)(1).

1. Distinct Assets

The Proposed Regulations analyze a distinct asset separately from any other assets to which it relates to determine if the distinct asset is real property, whether as land, an inherently permanent structure, or a structural component of an inherently permanent structure.²³ Listed Assets—buildings and other inherently permanent structures listed in proposed section 1.1031(a)-3(a)(2)(ii) and structural components listed in proposed section 1031(a)-3(a)(2)(iii)—are generally treated as distinct assets.²⁴

For assets that are not Listed Assets, the determination of whether a separately identifiable item of property is a distinct asset for purposes of section 1031 is based on all the facts and circumstances. In making this determination, the following questions must be considered:

- Is the item customarily sold or acquired as a single unit rather than as a component part of a larger asset?
- Can the item be separated from a larger asset, and if so, what is the cost of separating the item from the larger asset?
- Is the item commonly viewed as serving a useful function independent of a larger asset of which it is a part?
- Does separating the item from a larger asset of which it is a part impair the functionality of the larger asset?²⁵

No example in the Proposed Regulations specifically applies the factors above to determine whether property is a distinct asset. The definition of “distinct asset” in the Proposed Regulations, however, mirrors the definition of “distinct asset” in section 1.856-10(e), the regulation that defines the term “real property” for real estate investment trust (“REIT”) qualification purposes.²⁶ Example 8 of section 1.856-10(g) applies the distinct asset factors to determine whether each separately identifiable item of property in a solar energy site is a distinct asset. In the example, a REIT owns a solar energy site, among the components of which were land, photovoltaic modules (“PV modules”), mounts, and an exit wire. The PV modules convert solar photons into electricity. The mounts support the PV modules. The exit wire is buried underground, is connected to equipment that is in turn connected to the PV modules, and transmits the electricity produced by the PV modules to an electrical power grid. The example concludes that the PV modules, mounts, and exit wire are each a distinct asset because:

- The types of PV modules and exit wire that the REIT owned are each customarily sold or acquired as single units;

²³ Proposed section 1.1031(a)-3(a)(4)(i).

²⁴ Proposed section 1.1031(a)-3(a)(4).

²⁵ Proposed section 1.1031(a)-3(a)(4)(ii).

²⁶ See Lynn Afeman, Jaime Park, and David Lee, *Definition of “Real Property” for REITs*, *What’s News in Tax* (Oct. 24, 2016).

- Removal of the PV modules from the mounts that support them does not damage the function of the mounts as support structures and removal is not costly;
- Disconnecting the exit wire from the equipment to which it is attached does not damage the function of that equipment, and the disconnection is not costly;
- Separation from a mount does not affect the ability of a PV module to convert photons to electricity;
- Separation from the equipment to which it is attached does not affect the ability of the exit wire to transmit electricity to the electrical power grid; and
- The PV modules serve the active function of converting photons to electricity.²⁷

The preamble to section 1.856-10 notes that the analysis of Example 8 can be similarly applied in determining the extent to which components of an electric transmission and distribution system are considered real property. Given the Proposed Regulations’ broad borrowing from the REIT regulations, this example appears to provide helpful guidance as to how to identify a distinct asset for purposes of section 1031.

Once each distinct asset has been identified, the taxpayer must determine which of those distinct assets can be characterized as real property under the Proposed Regulations, whether as land, an improvement to land, or a real property interest. We examine each of these categories of real property in the following sections.

2. Land, Etc.

Under the Proposed Regulations, land and water and air space superjacent to land are considered real property for purposes of section 1031.²⁸ For example, boat slips and end ties are water space superjacent to land and are considered real property for purposes of section 1031.²⁹

Unsevered natural products of land, including growing crops, plants, and timber; mines; wells and other natural deposits, are also considered real property for purposes of section 1031.³⁰ Natural products and deposits, however, cease to be real property when they are severed, extracted, or removed from the land.³¹ For example, unsevered fruit-bearing plants are natural products of land and are real property for purposes of section 1031. Harvested fruit, however, ceases to be part of the land upon severance from the land and, therefore is not real property.³²

²⁷ *Id.* Example 8 of section 1.856-10(g) ultimately concludes that the mounts and the exit wire are real property but that the PV modules are *not* real property for purposes of the REIT qualification rules.

²⁸ Proposed section 1.1031(a)-3(a)(1).

²⁹ Proposed section 1.1031(a)-3(b), Example 2.

³⁰ Proposed section 1.1031(a)-3(a)(3).

³¹ *Id.*

³² Proposed section 1.1031(a)-3(b), Example 1.

3. Improvements to Land

Under the Proposed Regulations, the term “improvements to land” generally means “inherently permanent structures” (“IPSs”) and the “structural components” of an IPS.³³

Inherently Permanent Structures (IPSs)

For purposes of section 1031, an IPS means any building or other structure that (1) is a distinct asset, (2) is permanently affixed to real property, and (3) will ordinarily remain affixed for an indefinite period of time.³⁴ For this purpose, a building is any structure or edifice enclosing a space within its walls, and covered by a roof, the purpose of which is, for example, to provide shelter or housing or to provide working, office, parking, display, or sales space.³⁵

The Proposed Regulations provide a list of items that generally are included in the term “building.” These Listed Assets include houses, apartments, hotels, motels, enclosed stadiums and arenas, enclosed shopping malls, factory and office buildings, warehouses, barns, enclosed garages, enclosed transportation stations and terminals, and stores. Under the Proposed Regulations, the Listed Assets are distinct assets and generally are considered real property as IPSs if the assets are affixed to real property and will ordinarily remain for an indefinite period of time.³⁶

The Proposed Regulations also provide a list of “other inherently permanent structures” (“OIPS”). These Listed Assets include 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; grain storage bins and silos; and enclosed transportation stations and terminals. Under the Proposed Regulations, each of these items generally is a distinct asset and is considered real property as an IPS if the asset is permanently affixed to real property.³⁷

Finally, if an item of property is a distinct asset but is not an OIPS, the determination of whether the distinct asset is an IPS is based on the following factors:

- The manner in which the distinct asset is affixed to real property³⁸
- Whether the distinct asset is designed to be removed or to remain in place indefinitely

³³ Proposed section 1.1031(a)-3(a)(2)(i).

³⁴ Proposed section 1.1031(a)-3(a)(2)(ii)(A).

³⁵ Proposed section 1.1031(a)-3(a)(2)(ii)(B).

³⁶ *Id.*

³⁷ Proposed section 1.1031(a)-3(a)(2)(ii)(C).

³⁸ Affixation to real property may be accomplished by weight alone. *Id.*

- 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
- The time and expense required to move the distinct asset³⁹

To illustrate the application of these factors, the Proposed Regulations include as examples (1) a large sculpture in the atrium of an office building;⁴⁰ and (2) bus shelters, each of which consists of four posts, a roof, and panels enclosing two or three sides.⁴¹ Example 3 concludes that the sculpture is an IPS because it is permanently affixed to the building by supports embedded in the building’s foundation, is not designed to be removed but is designed to remain in place indefinitely, would be damaged and would damage the building to which it is affixed if removed, is expected to remain in the building indefinitely, and would require significant time and expense to move. Example 4, however, concludes that the bus shelters are not IPSs because they are not permanently affixed to the land or an IPS, are designed to be removed and not to remain in place indefinitely,⁴² would not be damaged if removed and would not damage the sidewalks to which they are affixed if removed, are not expected to remain affixed indefinitely, and would not require significant time and expense to move.

It is also worth noting that the Proposed Regulations require that “any circumstances that suggest the expected period of affixation is not indefinite” must be considered in determining whether a distinct asset is an IPS. Accordingly, in making the IPS determination under the factors, one must consider whether there are circumstances showing that the distinct asset may have to be moved. Caselaw from other contexts may be instructive on when such circumstances exist. For example, in *PDV America, Inc. v. Commissioner*,⁴³ the Tax Court held that the taxpayer’s above-ground petroleum storage tanks were not permanently affixed, and thus, were treated as five-year property for tax depreciation purposes. The court’s decision was based in part on the taxpayer’s contention that it had been foreseeable that it might have had to move the tanks for maintenance, environmental remediation, or various business or economic reasons. This type of analysis may be relevant in determining whether an asset is an IPS for purposes of section 1031. However, the final determination of whether an asset is an IPS for purposes of section 1031 is based on *all* the factors provided in the Proposed Regulations and is not dependent on the property’s characterization for other purposes of the Code.⁴⁴

³⁹ *Id.*

⁴⁰ Proposed section 1.1031(a)-3(b), Example 3.

⁴¹ Proposed section 1.1031(a)-3(b), Example 4.

⁴² For example, the bus shelters are disassembled and moved when bus routes change.

⁴³ T.C. Memo. 2004-118. The analysis in *PDV America, Inc.* is based on six factors articulated in *Whiteco Industries, Inc. v. Commissioner*, 65 T.C. 664 (1975). These factors have been analyzed by the courts and the IRS numerous times and these prior analyses may be potentially helpful when making an IPS determination under section 1031. See Lynn Afeman, Jaime Park, and David Lee, *Definition of “Real Property” for REITs*, What’s News in Tax (Oct. 24, 2016).

⁴⁴ Proposed section 1.1031(a)-3(a)(6). For example, a structure or portion of a structure may be section 1245 property for tax depreciation purposes and for determining gain under section 1245, notwithstanding that the structure or portion of the structure is real property for purposes of section 1031.

Structural Components

Under the Proposed Regulations, the term “improvements to land” includes not only IPSs (such as buildings) but also includes structural components of IPSs. For purposes of section 1031, a structural component is any distinct asset that is a constituent part of, and integrated into, an IPS.⁴⁵ If interconnected assets work together to serve an IPS, those assets are generally analyzed as one distinct asset that may be a structural component. For example, each system that provides a building with electricity, heat, or water, may be analyzed as one distinct asset.⁴⁶ In addition to serving an IPS, a structural component qualifies as real property under the Proposed Regulations only if the taxpayer holds its interest in the structural component together with a real property interest in the space in the IPS served by the structural component.⁴⁷

The Proposed Regulations provide a list of structural components that are generally considered to be real property provided that (1) they are constituent parts of, and integrated into, an IPS; and (2) the taxpayer holds its interests in the component together with a real property interest in the space in the IPS served by the structural component.⁴⁸ These Listed Assets include 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; and humidity control systems.

If a component of a building or IPS is a distinct asset and is not listed above, the determination of whether the component is a structural component of the IPS and, therefore, real property is based on the following factors:

- 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 distinct asset would cause to the item itself or to the IPS to which it is affixed
- Whether the distinct asset is installed during construction of the IPS⁴⁹

To illustrate the application of these factors, the Proposed Regulations include as an example a taxpayer that owns an office building that includes two types of interior, non-load-bearing drywall partition systems: a conventional drywall partition system (the conventional system) and a modular drywall partition system (the modular system).⁵⁰ Neither system was installed during construction of the

⁴⁵ Proposed section 1.1031(a)-3(a)(2)(iii)(A).

⁴⁶ *Id.*

⁴⁷ *Id.*

⁴⁸ Proposed section 1.1031(a)-3(a)(2)(iii)(B).

⁴⁹ *Id.*

⁵⁰ Proposed section 1.1031(a)-3(b), Example 9.

office building. Both reach from floor to ceiling. Each is a distinct asset for purposes of the Proposed Regulations.

The conventional system is composed of fully integrated gypsum board partitions, studs, joint tape and covering joint compound. Depending on the needs of the tenant, the conventional system may remain in place when a tenant vacates the premises. The system is integrated into the office building and is designed and constructed to remain in areas not subject to reconfiguration or expansion. The conventional system may only be removed by demolition and, once removed, neither the conventional system, nor its components can be reused. Removal of the conventional system causes substantial damage to the system itself but does not cause substantial damage to the building.

The modular system, on the other hand, is composed of assembled panels, studs, tracks, and exposed joints. The modular system is not designed or constructed to remain permanently in place. The system is designed to be movable and it is typically removed when a tenant vacates the premises. Each modular system can be readily removed, remains in substantially the same condition as before, and can be reused. Removal of a modular system does not cause any substantial damage to the system itself or to the building. The modular system can be moved to accommodate the reconfiguration of the interior space within the office building for various tenants that occupy the building.

The example concludes that the conventional system is integrated into an IPS and is a Listed Asset as a structural component of an IPS under proposed section 1.1031(a)-3(a)(2)(iii)(B). Thus, the conventional system is real property for purposes of section 1031. The modular system, however, is not integrated into an IPS and therefore is not a Listed Asset. Under the factors applicable to structural components, the modular system is not a structural component that can be considered real property for purposes of section 1031. In particular, the modular system (1) is installed and removed quickly and with little expense; (2) is designed to be moved and is not designed specifically for the particular building of which it is a part; (3) is not damaged upon its removal; (4) does not damage the building upon its removal; and (5) was not installed during the construction of the building. The example concludes that the modular system is not real property for purposes of section 1031.

Structural Components in the Nature of Machinery

The Proposed Regulations acknowledge that in certain circumstances an IPS can have a structural component that is in the nature of machinery, but which should still be treated as real property for purposes of section 1031. As a structural component under the Proposed Regulations, property that is in the nature of machinery must be a constituent part of, and integrated into, an IPS. Moreover, the taxpayer must hold property in the nature of machinery together with a real property interest in the space in the IPS served by the property. In other words, as an initial matter, to be real property, any item of property in the nature of machinery must meet the definition of a structural component of an IPS as defined in the Proposed Regulations.

Satisfaction of the structural component criteria, however, is not sufficient under the Proposed Regulations for property in the nature of machinery to be considered real property. In addition to being

a structural component of an IPS, property in the nature of machinery must (1) serve the IPS, and (2) not produce or contribute to the production of income other than for the use or occupancy of space.⁵¹

Although the Proposed Regulations provide no definition of the term “machinery” or specific factors to apply to determine if property should be considered “property in the nature of machinery,” the Proposed Regulations do include several examples that illustrate the requirements for determining whether property in the nature of machinery is a structural component of an IPS. In Example 5, for instance, the taxpayer 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 in a backup capacity. The 3D printer weighs 12 tons and is designed to remain in place indefinitely once installed in the building. The 3D printer was installed during the building’s construction. The generator was also installed during construction and is designed to remain in place indefinitely once installed.⁵²

Example 5 concludes, based on the factors above, that the 3D printer is machinery and is not an IPS. Although the printer is permanently affixed by virtue of its weight and was installed during the construction of the building, the printer produces income other than for the use or occupancy of space. Accordingly, the 3D printer is not a structural component in the nature of machinery and, therefore, is not real property for purposes of section 1031.⁵³ The generator, on the other hand, services the entire building in a back-up capacity and does not generate income other than for the use and occupancy of the building. The generator is property in the nature of machinery as a structural component and is real property for purposes of section 1031.⁵⁴

In contrast to the facts of Example 5, the taxpayer in Example 6 had installed the electrical generator for the purpose of keeping the 3D printer operating in the event of a power outage. The generator, which is generally machinery, was installed to service the operation of the 3D printer and not the building. Example 6 therefore concludes that the electrical generator is not real property for purposes of section 1031.⁵⁵

Consistent with its conclusion in the 2012 CCA, Example 8 of the Proposed Regulations concludes that a steam turbine which is a component of a system that produces power for the taxpayer’s building and also is used for the commercial production of electricity for sale to customers in the ordinary course of the taxpayer’s business as an electric utility was not real property for purposes of section 1031. Although the steam turbine has some characteristics of a structural component of an IPS because it is permanently affixed, installed during construction of the building, and serves the taxpayer’s building, the steam turbine is machinery that produces income other than for the use or occupancy of space. Therefore, the steam turbine is not real property for purposes of section 1031.⁵⁶

⁵¹ Proposed section 1.1031(a)-3(a)(2)(ii)(D).

⁵² Proposed section 1.1031(a)-3(b), Example 5.

⁵³ *Id.*

⁵⁴ *Id.*

⁵⁵ Proposed section 1.1031(a)-3(b), Example 6.

⁵⁶ Proposed section 1.1031(a)-3(b), Example 8.

Focusing on the function of a structural component that might in the nature of machinery, however, is inconsistent with portions of the preamble to the Proposed Regulations. In particular, in explaining why the IRS did not simply adopt the section 1.856-10 definition of real property wholesale for purposes of section 1031, the preamble specifically provides that although section 1.856-10 provides that property having an active function such as producing, manufacturing, or creating a product is not real property under section 856, “...nothing in pre-TCJA section 1031 law suggests that real property held for productive use in a trade or business or for investment should necessarily be excluded from the definition of real property because of an active rather than a passive function.” Nevertheless, for property in the nature of machinery, the IRS included a requirement based on the active function of the asset even though the asset is permanently affixed to an IPS in such a way to otherwise qualify as an improvement to land as a structural component of the IPS. It is unclear why the function or use of an asset that is a constituent part of, and integrated into, an IPS is relevant if nothing in the pre-TCJA law indicates that property should be excluded from the definition of real property simply because of an active function.

For example, in Example 5 of the Proposed Regulations, the IRS concludes that a generator that serves a building in a backup capacity was real property but the same generator that served only a printer would be personal property because, in the latter case, the generator contributed to the production of income. Similarly, in Example 8, the turbine which otherwise met the requirement of a structural component was personal property because, in addition to providing power to the taxpayer’s building, the turbine contributed to the taxpayer’s commercial production of power. In other words, the generator in Example 5 which potentially powers the building is real property (because the use supports the occupancy of the building) but the turbine in Example 8 that actually powers the building is personal property because it is also used in the taxpayer’s trade or business. If an active function is not relevant to the real property determination in section 1031 as the IRS suggests in the preamble to the Proposed Regulations, it is unclear why the function of the generator or the turbine disqualifies the permanently affixed property from inclusion in a like-kind exchange.

In addition, in the preamble to the Proposed Regulations and in the definition of “building” in proposed section 1.1031(a)-3(a)(2)(ii)(B), the IRS also suggested that the function of an asset may be more broadly relevant in determining whether an asset is real property. The Proposed Regulations provide that a building is any structure enclosing a space within its walls, and covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, parking, display or sales space. If the function of a building is not relevant to its characterization as real or personal property for purposes of section 1031, it is unclear why the “purpose” of the building is described in the definition.

Similarly, in the preamble, the IRS stated that a gas line that provides fuel to a building’s heating system comprises part of the structural component that is the heating system, and therefore, qualifies as real property for section 1031 purposes. However, if the purpose of the gas line is to provide fuel to business equipment in a building, for example fryers and ovens in a building utilized as a restaurant, the

gas line is not a constituent part of an IPS and therefore is not real property for purposes of section 1031.⁵⁷

This distinction based on the function of the gas line is odd for several reasons. First, the gas line presumably might have been analyzed as an IPS, rather than a structural component of an IPS. In most, if not all cases, the gas line will be buried in the ground or located behind the wall or under the floor of a building. Thus, the gas line, regardless of any purported function, could have been characterized as an OIPS under the Proposed Regulations. If the IRS were to have analyzed the gas line in this way, it would not have been necessary to determine whether it “serves” an IPS or satisfies the requirements for a structural component.⁵⁸

Second, it is not clear why the IRS believes that an embedded gas line that is used to provide fuel for equipment in a building housing a restaurant, such as an oven, should be treated differently than a gas line that provides fuel for a boiler in the same building. In many buildings, the same gas system will serve both. Neither the preamble nor the Proposed Regulations provide much clarity as to how a gas line that is not an IPS would be analyzed in these circumstances when the asset serves a dual purpose for the taxpayer. For example, if a building has one gas line that provides fuel to both the building’s heating system and business equipment within the building (e.g., an oven) is the gas line like the steam turbine in Example 8 and completely excluded from the building’s structural components because the gas line produces or contributes to the production of income other than for the use or occupancy of space?

In the REIT context, where the active or passive function of an asset is relevant, the IRS addressed the issue of property that may have a dual use to the taxpayer. Under section 1.856-10(d)(3)(i), to qualify as real property, a structural component must serve an IPS in its passive function, and, even if capable of producing income other than consideration for the use or occupancy of space, must not produce or contribute to the production of such income. The IRS indicated in the preamble to those regulations that it was considering guidance to address the treatment of any income earned when a system that provides electricity to an IPS held by a REIT also transfers excess electricity to a utility company. Until additional guidance is published, the IRS stated in the preamble that, in any taxable year in which the quantity of excess electricity transferred to the utility company from the REIT from such distinct assets does not exceed the quantity of electricity purchased by the REIT from the utility company during the taxable year to serve the IPS, the IRS will not treat the transfer of such excess electricity as affecting the qualification of such distinct assets as structural components of the IPS for REIT purposes.⁵⁹ In this narrow case, the dual use of the property did not adversely impact the characterization of the asset as real property because, on net, the asset did not produce or contribute to the production of income other than for the use or occupancy of space. The Proposed Regulations provide no such exception.

⁵⁷ Preamble to the Proposed Regulations.

⁵⁸ See, e.g., section 1.856-10(g), Example 8 (concluding that an exit wire which is buried underground and transmits electricity to a power grid was real property for REIT qualification purposes); note 27, *supra*.

⁵⁹ 81 Fed. Reg. 59849 (Aug. 31, 2016).

The breadth of this focus on the function of an asset and its impact on the characterization of the asset as real property under the Proposed Regulations is particularly unclear when it comes to property that provides multiple uses, some (but not all) of which, taken alone, would permit the property to be treated as a structural component under the Proposed Regulations. Moreover, if property in the nature of machinery satisfies the criteria to be a structural component of an IPS under the Proposed Regulations, perhaps the property should be considered real property for purposes of section 1031, despite any characteristics that it possesses in the nature of machinery. More clarity as to the situations, if any, in which function is relevant for the real property determination under section 1031 would be helpful.

4. Interests in Real Property—Intangible Assets

The term “real property” for purposes of section 1031 also includes certain interests in real property, and intangible assets. These interests include fee ownership, co-ownerships, leaseholds, options to acquire real property,⁶⁰ easements, and other similar interests.⁶¹ To qualify as real property, the intangible asset must derive its value from real property or an interest in real property, must be inseparable from that real property or interest in real property, and must not produce or contribute to the production of income other than consideration for the use or occupancy of space.⁶² For example, a license, permit or other similar right that is solely for the use, enjoyment, or occupation of land or an IPS and that is in the nature of a leasehold interest in real property, easement, or fee ownership may be considered a real property right for purposes of section 1031.⁶³ A license or permit to operate a business on real property, however, is not a real property interest for purposes of section 1031.⁶⁴ In addition, consistent with pre-TCJA law, shares in a mutual ditch, reservoir, or irrigation company described in section 501(c)(12)(A)⁶⁵ are considered real property interests if, at the time of the exchange, the shares have been recognized by the highest court of the state in which the company is organized, or by a state statute, as constituting or representing real property or an interest in real property.⁶⁶

The legislative history to the TCJA provided that real property eligible for like-kind exchange treatment under pre-TCJA law should continue to be eligible for like-kind exchange treatment after the enactment of the TCJA.⁶⁷ Prior to the TCJA, the IRS in private letter rulings had concluded that many of these

⁶⁰ Inclusion of an option to acquire real property as a potential real property asset for purposes of section 1031 is a welcome clarification. *See, e.g.,* Biggs v. Commissioner, 632 F.2d 1171 (5th Cir. 1980); Koch v. Commissioner, 71 T.C. 54 (1978); Mohlbreak v. Commissioner, 61 T.C. 382 (1973), *aff'd*, 509 F.2d 616 (7th Cir. 1975); Field Service Advisory (May 30, 1995), 1995 WL 1770869. It is important to note, however, that the Proposed Regulations do not indicate what property is like-kind to an option to acquire real property. In particular, it is unclear whether an option is like-kind only to another option to acquire real property or whether it is like-kind to a broader array of real property assets (*e.g.*, a fee interest in real property).

⁶¹ Proposed section 1.1031(a)-3(a)(1).

⁶² Proposed section 1.1031(a)-3(a)(5)(i).

⁶³ Proposed section 1.1031(a)-3(a)(5)(ii).

⁶⁴ *Id.*

⁶⁵ A mutual ditch, reservoir, or irrigation company generally is described in section 501(c)(12)(A) if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses.

⁶⁶ Proposed section 1.1031(a)-3(a)(5)(i).

⁶⁷ Preamble to the Proposed Regulations.

interests in real property were real property for purposes of section 1031 because of the property’s classification under relevant local law.⁶⁸ For example, under pre-TCJA authorities, a taxpayer’s interest in a cooperative apartment may qualify as real property for purposes of section 1031. An interest in a cooperative apartment typically includes stock in a cooperative corporation that owns the building and common areas and an interest in a long-term lease in the particular apartment. The IRS has previously concluded the taxpayer could exchange its interest in the cooperative apartment (including the shares of stock) for a fee interest in other property or a condominium interest in the same apartment under section 1031.⁶⁹ The Proposed Regulations do not indicate whether a different conclusion should be reached under the proposed definition of “real property” if local law is no longer the basis for this determination other than for mutual ditch, reservoir, or irrigation companies. However, given the legislative history to the TCJA, presumably those assets that were considered real property under pre-TCJA authorities should continue to qualify for like-kind exchange treatment under section 1031 after the enactment of the TCJA.

Conclusion

The Proposed Regulations provide much-needed guidance on the eligibility of property for inclusion in a like-kind exchange under section 1031. Although there are some areas in which more guidance or clarification may be desired, the Proposed Regulations are comprehensive and propose a generally clear framework for answering this critical question for taxpayers engaging in like-kind exchanges under section 1031.



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⁶⁸ See, e.g., PLR 200901020 (Jan. 2, 2009) (residential density development rights); PLR 200805012 (Feb. 1, 2008) (transferable development rights); PLR 200649028 (Dec. 8, 2006) (development credits or stewardship easements).

⁶⁹ PLR 200631012 (Aug. 4, 2006); PLR 200137032 (Sept. 14, 2001); PLR 8810034 (Dec. 10, 1987); PLR 8445010 (July 30, 1984).